

PAKISTAN
EXPORT DIVERSIFICATION AND TRADE POLICY
FINAL REPORT

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ABBREVIATIONS AND ACRONYMS

AEO	Authorized Economic Operator	NLC	National Logistics Cell
ATP	Annual Trade Policy	NLTA	Non- Lending Technical Lending Assistance
ATTA	Afghan Transit Trade Agreement	NTC	National Tariff Commission
BRIC	Brazil, Russia, India and China	NTCIP	National Transport Corridor Improvement Program
CAR	Central Asian Republics	NTTFC	National Trade and Transport Facilitation Committee
DDRs	Duty drawback rates	OIC	Organization of the Islamic Conference
DG	Director General	OTRI	Overall Trade Restrictiveness Index
DTRE	Duty & Tax Remission on Export	PaCCS	Pakistan Customs Computerized System
EDB	Export Development Board	PIFFA	Pakistan International Freight Forwarders Association
EDB	Engineering Development Board	PITAD	Pakistan Institute of Trade and Development
EFC	Export Finance Scheme	PPP	Pakistan People's Party
EM	Extensive margin	PPP	Public-Private Partnership
EP	Exportable products	PSCB	Pakistan Public Sector Capacity Building
EPB	Export Promotion Board	PTA	Pakistan Tanners Association
EPZs	Export Processing Zones	QRs	Quantitative restrictions
EU	European Union	R&D	Research and Development
EXPY	Export Sophistication	RCA	Revealed comparative advantage
FBR	Federal Bureau of Revenue	REGS	Rapid Export Growth Strategy
FDI	Foreign Direct Investment	SAFTA	South Asian Free Trade Agreement
FTA	Free Trade Agreement	SBP	State Bank of Pakistan
FTIP	Foreign Trade Institute of Pakistan	SMART	System of Market Analysis and Restrictions of Trade
GCC	Gulf Cooperation Council	SME	Square Meter Equivalent
GD	Goods Declaration	SROs	Statutory Regulation Orders
GD	Director- General	T&C	Textiles and Clothing
GDP	Gross Domestic Product	TDAP	Trade Development Authority of Pakistan
GOP	Government of Pakistan	TFP	Total factor productivity
GSP	General System of Preferences	TIR	Transports internationaux par la route
HS	Harmonized System	UAE	United Arab Emirates
ICP	Indian Civil Service	UK	United Kingdom
IM	Intensive margin	UNCTAD	The United Nations Conference on Trade and Development
IMF	International Monetary Fund	US	United States
IPP	Independent Power Producers	WAPDA	Water and Power Development Authority
IT	Information Technology	WBI	World Bank Institute
KDLB	Karachi Dock Labor Board	WDI	World Development Indicators
KICT	Karachi International Container Terminal	WeBOC	Web Based One Customs
LMM	Locally Manufactured Machinery	WITS	World Integrated Trade Solutions
LPI	Logistics Performance Index	WTO	World Trade Organization
LTF-EOP	Long-term Financing for Export Oriented Projects		
LTFF	Long-Term Finance Facility		
MAF	Million acre feet		
MFA	Multi-Fiber Agreement		
MFN	Most Favored Nation		
MOC	Ministry of Commerce		
NABA	National Accountability Bureau		

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PAKISTAN EXPORT DIVERSIFICATION AND TRADE POLICY

EXECUTIVE SUMMARY

Introduction

1. Pakistan's trade indicators reflect low outward orientation, concentration on low value added activities and an undiversified product mix which out of line with the fastest growing areas of world demand. The export share of Gross Domestic Product (GDP) has remained low and falling—from 13 to 11 percent in 2010, while 45 products account for around 83 percent of exports, with 10—mostly from the textiles and garment sector—representing more than half. As a result, textiles and garments share of exports has been consistently exceeded 60 percent while food and leather accounted for an additional 17 percent and engineering, barely 2 percent. On the other hand, the engineering share of world trade has grown to 60 percent from rising export powers in East Asia and Latin America, while the world's textile shares have remained at stagnant 6 percent, but even here, strengthening competitors is South Asia, new competitors in South East Asia are competing for a stagnant 6 percent of world trade, making competition even more fierce in the commodities in which Pakistan's traditionally specializes.

2. There have been many good signs in Pakistan's trade performance in recent years which provides a strong basis to build upon, as the policy mix considers the role of trade in Pakistan's growth agenda. While, there have been periods of low growth, usually in response to recession in developed countries, when the world grows and Pakistan's policies are conducive to trade orientation, a strong supply response is witnessed. Greater diversification occurred during the 2000s with the share of exports going to textiles falling from 68 percent in 2003-04 to 55 percent in 2007-08 to 52 percent in 2010-2011. The rising share of note during this period was food (from 10 to 14 percent) and other manufactures (from 16 to 20 percent), but there was considerable attempts at export diversification – both new products and new markets—at low levels, often unsustainable levels of activity.

3. Pakistan currently faces a difficult challenge of stabilizing, reforming and growing, all under difficult conditions of commodity price volatility, tight finance and dampened world demand. The persistent deterioration in the global economy has certainly created difficult external conditions for developing countries to transform, strengthen and diversify their own economies through export led strategies. For countries like Pakistan which export to the markets experiencing the largest contraction, renewed demand for their exports will require additional time to enable excess labor and unbalanced fiscal positions to be accommodated, possibly forestalling high demand conditions for some years to come.

4. Still, both in spite of, as well as because of the most difficult world and home market conditions in recent memory, Pakistan faces little choice but to reduce exporting biases and position

its business sector to look outward for prosperity, once markets revive. The ability to expand, diversify and upgrade production requires imported capital goods and intermediates as part of the global supply chain process. Increased exports are needed to offset the shrinking invisible account surplus as well, thereby providing scarce balance of payments financing. Most importantly however, export growth remains an outcome of productive, innovative and sophisticated firms. As such, attention to success in exporting—along with its many behind-the-border, at-the-border and other-side-of-border success factors—has been, and continues to be, a central theme and policy goal in economic management in recent months and for years to come.

Pakistan's Starting Conditions

5. Crises have indeed also been important features of Pakistan's history. Several of these have had profound consequences for the shape of the economy, the structure of its political system, and the way the country's citizens look at the world outside. In dealing with them, the policymakers of the day adopted approaches that left their mark on the development of the country. Crises were caused by different sets of circumstances, and have numbered into the double digits, depending on how one characterizes crises. Four crises are highlighted due to their very strong impact on the economic structure today.

- ***Dividing Society***: Before Pakistan emerged as an independent Muslim state, colonial rulers in British India became concerned that the economic system was putting the Muslims under considerable economic pressures, particularly in Muslim dominated areas. While the laws that were put on the books to protect the Muslim peasantry achieved the objective, there were unintended consequences of exacerbating the Muslim-non-Muslim divide and contributed to the mass movement of people in the months around the time of the carving out of a new Muslim state. Resettling refugees and social divide has become an enduring challenge for realizing the benefits of economic integration—nationally, regionally and internationally.
- ***A Difficult Neighborhood***: In the years immediately following the partition of India and the creation of Pakistan, the creation of a predominantly Muslim Pakistan and a predominately non-Muslim India led to potential conflict that surfaced the moment Pakistan was born. There was the perception among the first generations of Pakistani leaders that first administration in India was attempting to undo partition and fold back the newly created Muslim state into India. This perception was to become the basis of public policymaking in Pakistan for decades and led to a series of crises related to the emerging conflict with India—deeply affect the structure, direction and performance Pakistan's economy ever since.
- ***State Dominance of the Economy***: The ideological underpinnings of the administration in power was more important as the source of crises in India than was the case for Pakistan as for almost four decades, the Indian state was put on the commanding heights of the economy. However, in Pakistan two administrations devised and implemented economic policies based on ideology: socialism in the case of Prime Minister Zulfikar Ali Bhutto (1971-77) and Islam in the case of President Ziaul Haq (1977-88). While the changes were less substantive in the latter case, in the former case, the policies adopted had lasting adverse consequences.

- **Impact of Poor Governance:** Two periods in Pakistan's history are relevant: the first in the decade following the birth of the country when there was enormous jockeying for power, no institutions to intermediate between contending political forces and the resulting political chaos and economic confusion. Pakistan was placed under military rule and a new economic model due to the differences among the newly empowered political forces.¹ Neither he nor his program survived and he was forced to resign. Poor governance of a similar type reappeared in 2008-12, causing an already bad economy to turn to crisis.

6. Despite and because of these crises, Pakistan's position in world trade has changed little over the past three decades. As Pakistan's market share in the world has been declining during the last several years, those of Malaysia, Mexico and Thailand have doubled, and China's has tripled. Pakistan's average trade-to-GDP ratio in the late 2000s was roughly the same as a decade earlier and has been declining in recent years. Along with this declining export share, two markets - the United States (US) and the European Union (EU) - absorb two thirds of Pakistan's total exports while the export bundle's reliance on a few commodities making it highly susceptible to global market volatility of type which has become commonplace.

7. Meanwhile, aided by large reductions in trade barriers and technological advancements, export oriented countries led by China and India and other emerging markets have become major drivers of global trade in goods and services, respectively. Moreover, world trade has undergone a dramatic transformation toward the global fragmentation of production, resulting in greater trade flows, particularly within supply chains, and an increased the variety in the types of traded goods and services—a trend that has largely eluded Pakistan.²

8. This evolving trade landscape is likely to exact more pressure on firms in other developing economies to improve productivity through better industrial organization, in order to enhance its “trade competitiveness” and benefit from the growing opportunities for new entrants on the international market. However, growth and competitiveness requires more than abstract formulation carried out in isolation. Increasingly, competitive countries are taking aggressive steps to enhance domestic competitiveness in order to measures up to competitors who are doing the same.

9. Pakistan's current and potential competitors, even those with similar endowments of skill and technological capacities at present have become relatively more open and more integrated in world trade, and as a result recorded large gains in the amount or exporting firms were successfully recording. Successful performers are not restricted to China and East Asia's “new Tigers” like Indonesia, Malaysia, Thailand, the Philippines and Vietnam but also include Turkey, Costa Rica, Chile, and Mauritius.

10. In most countries a significant reduction in anti-export bias was achieved as result of maintaining relatively low tariffs and a competitive exchange rate, supplemented by effective regulatory regimes. The result has been to reduce forced idleness of resources, eliminating or

¹ Muhammad Ayub Khan, *Friends not Masters: A Political Autobiography*, London, Oxford University Press, 1967.

² World Bank, 2010.

reducing allocative and 'X-inefficiency enabling gains in total factor productivity (TFP) which are key in enhancing trade competitiveness.³

11. The need for trade for reform, and the scope and pace of reform, need to be considered from both a wider competitiveness dimension than just a physical distance to competitors and peers. The investment climate, trade policy, infrastructure and knowledge as well as the incentive structure and the institutions to facilitate are important elements of a trade and competitiveness strategy. Export diversification will follow a flexible, dynamic and open set of factor and product markets – with product markets by all means encompassing both the domestic market and international markets – particularly since Pakistan's competitors, are paying the price to remain at its door to exert pressure on its firms, and are more competitive in Pakistan's export markets. The complexity of the new trade landscape calls for a more integrated approach to achieving Pakistan's declared goals for trade and industrial development in order to create an incentive environment conducive to trade competitiveness and export diversification.

A Conceptual Framework for Trade Competitiveness

12. Studies on competitiveness have made it clear that the determinants of competitiveness are many and complex. There is now little doubt that, in the long run, economies more open to trade show stronger economic growth and overall development performance, including export growth.⁴ The arguments for investment in physical capital and infrastructure, coupled with appropriate macro, micro and governance fundamentals so that resources naturally flow into the right sectors, and within those sectors, to the right firms. Further human and social capital, soft infrastructure, support for technology related innovation, business friendly environments, sound markets, property rights regimes, were all complementary areas for the public sector contribute, in order to maintain the productivity and operational efficiency achieved from inter-firm and inter-industry linkages.

13. A good practice export competitiveness initiative underscores several of the above issues and draws on the myriad of policy tools and approaches employed around the world on trade, macroeconomic policy, customs and logistics, and direct enterprise support. It emphasizes the importance of global integration in achieving competitiveness – be it through new technologies, market-integrating economic policies. The policy agenda that typically emerges from a competitiveness analysis relates to three or four core areas with Education and health often considered a fourth distinct core area.

- *Macro fundamentals* (e.g., removal of economic biases having to do with tariff and non-tariff barriers, real exchange rate misalignment, distortive tax regime, overall fiscal health of the

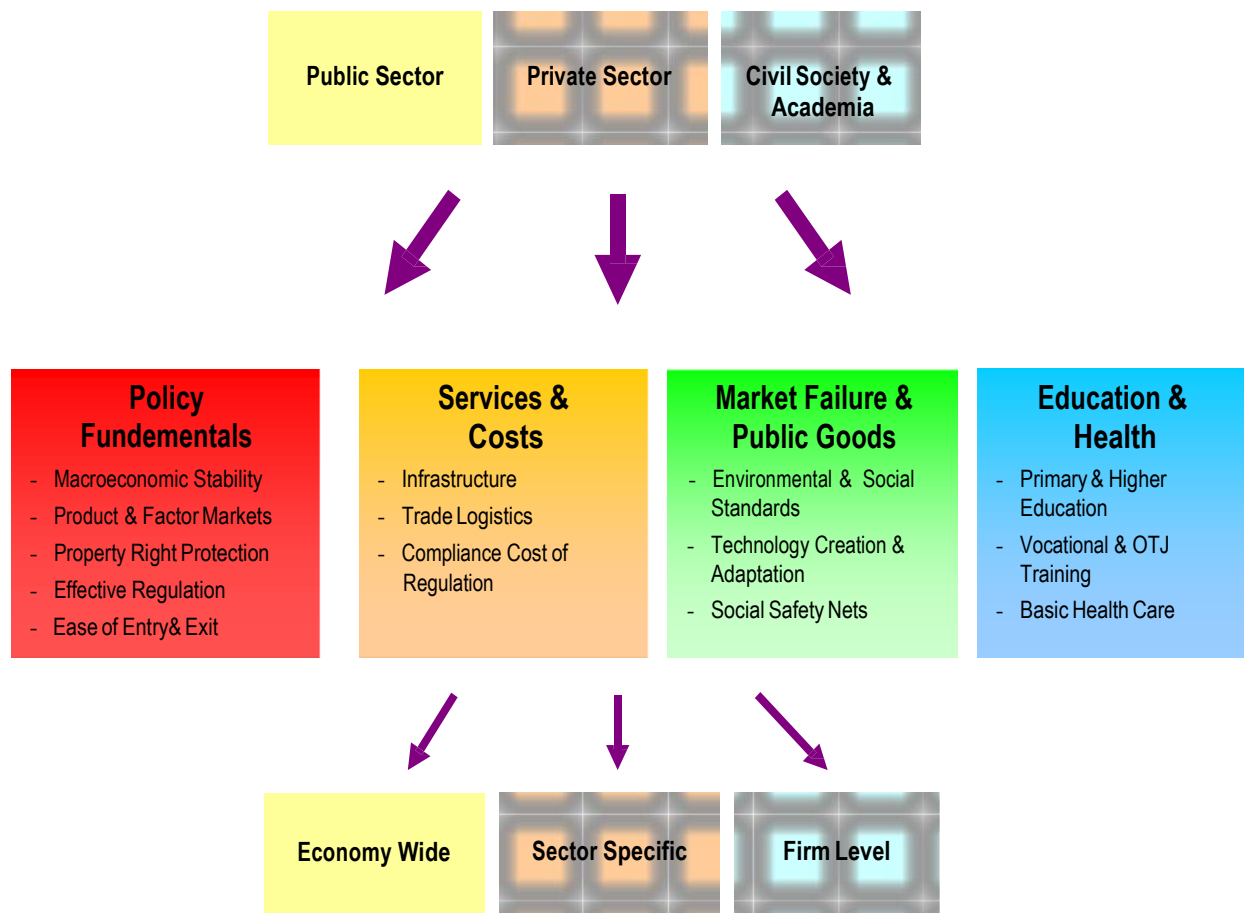
³ Amiti and Kronin, 2007, Jayanthakumaran 2004. In particular, see Jayanthakumaran (2004) for a survey of literature discussing trade liberalization and trade growth linking to TFP growth.

⁴ Dollar, D. and A. Kraay (2004). "Trade, Growth, and Poverty", *Economic Journal* (2004); Dollar, D. and A. Kraay (2002). "Growth is Good for the Poor", *Journal of Economic Growth*; Michaely, M., D. Papageorgiou, and A. Choksi (1991). *Liberalizing Foreign Trade: Lessons of Experience in the Developing World* (Oxford: Basil Blackwell); Winters, L. Alan, N. McCulloch, and A. McKay (2004). "Trade Liberalization and Poverty: The Evidence So Far", *Journal of Economic Literature*, Vol, XLII (March).

economy, product and factor market conditions, property right protection, effective regulation, ease of firm entry and exit).

- *Services and costs* (e.g., infrastructure, customs and trade logistics, the costs of doing business including compliance cost of regulation).
- *Proactive measures that try to correct market failures and develop public goods* (e.g., technology creation and adaptation, product standards and certifications, export promotion, environmental and social standards, social safety nets).
- *Education and health* (e.g., primary and higher education, vocational and on-the-job training, basic health care).

Pro Forma Analytical Framework for Trade Competitiveness



14. The focus of the report is to reinforcing the arguments embodied in this analytical framework for trade competitiveness, focusing on the principal areas facing Pakistan's policy makers, first by analyzing Pakistan's historical underpinning of its initial conditions, trade outcomes, and policy issues and analytical needs related to improving trade competitiveness.

Competitiveness through Trade Outcomes

15. Export Competitiveness is defined as the ability of the economy to adjust to changes and continue selling its products. From a country's perspective this would involve expansion at the extensive and intensive margins, but the two mean the same in terms of export receipts. However, in terms of specifics, where are the jobs, the foreign exchange inflow, the income, etc.

16. The analysis of trade outcomes show mixed results, from both the short and longer term perspective. At the heart of the long term issue is that Pakistan's trade orientation is very low and its traded products are at the unsophisticated end of the technology spectrum. Both facts have been dominant characteristics of Pakistan's trade outcomes for some time. In terms of more immediate challenges of growth what Pakistan exports, there have been large growth spurts in the past, but these have tempered dramatically in recent years, and the over all trend is a declining one.

17. On the positive side, the level of diversification is higher than implied by the top sectors or products share of exports, indicating, low level product exports. There are also positive signs at the firm level which indicating entry and exit dynamics that are promising in terms of future competitiveness, once these firms achieve success and are able to scale up. There is significant churning at the country margin and some healthy creative destruction at the firm margin. The product/sector margin has been less dynamic.

18. Three outcomes speak the how well the economy is showing the appropriate dynamics, resource allocation and creative destruction needed to maintain competitiveness.

- The first dimension is about static outcomes, reflecting the initial conditions described in Chapter Three outcomes are examined: (i) Trade orientation and export growth, (ii) product and market diversification and (iii) process upgrading
- The second dimensions is about breaking down changes in trade flows into separate and analyzable components, including extensive margins(how well is performance in new products and markets) and intensive margins(how well is performance in existing products and markets).
- The third dimensions is to examine what is happening at the firm level, in terms of firm entry and exit, introduction of new products/ sector, and penetration into new markets, to understand how the dynamics seen at the product level is being reflected in firm level performance.

19. Recent trade patterns in Pakistan are viewed from two perspectives: trade flows by products (irrespective of the firms which originate them), and export activity by firms (according to the products they produce). The perspective is to examine, to the extent possible, dynamic forces at work behind the trade flows to so how, the country's systems for allocating resources is leading to positive trade outcomes.

20. Trade orientation in goods is low and decreasing, goods are low tech, and trading partners are dominated by a few developed economies. Specifically,

- The trade orientation here is described in terms of outward looking of the economy – trade to GDP, which as 32 percent is half of what it should be. Other countries have reached that China and India but Pakistan has stayed constant and even fell a decade ago.
- From a sector point of view, Pakistan's exports are dominated by labor-intensive light manufacturing -- like textiles, clothing, footwear, leather and agri-foods. This group's share in exports in 2007-09 was 65 percent. The second most important export sector was the agrifood sector with slightly more than 11 percent of total exports.
- The technological content of exports in Pakistan is low. High-tech exports constituted less than 2 percent in 2008, a share broadly unchanged in the past 25 years.⁵
- The low level of export sophistication in Pakistan. Pakistan's increase in export sophistication is modest. In 1986, the sophistication of its export basket was higher than that of Vietnam. In past 20 years, Pakistan export basket has not undergone an improvement as its Asian peers.
- The US and European markets⁶ absorb 31 percent and 23 percent of Pakistan's total exports, respectively with China represents the third most important destination, with a 11.5 percent. Gulf (UAE, Afghanistan, Oman) destinations are important re-export destinations.

21. Trade in Services has been a potential bright spot as a nice set of products spurred by considerable technology transfer from foreign direct investment in telecoms and banking. Both types of FDI have since ebbed due to security considerations, but the service exports from the past FDI is currently showing some pay off. Specifically,

- Trade in services, although only partially seen in official statistics, has acquired momentum, possibly because it can override tangible, physical constraints faced by the goods sector.
- Increasingly, services trade became an important source of export diversification in Pakistan but less so than its peer countries: Bangladesh, China, Egypt, India, Malaysia, and Turkey. Outside Bangladesh, Pakistan has the lowest share of services in GDP among its peers.
- Between 2000 and 2007, exports of commercial services grew at a compound annual rate of nearly 15 percent, which is just below the average rate of peer countries.

⁵For example, Vietnam's share of high-tech exports went from 0.7 percent to 3.8 percent of total in the same period whereas India's increased from 2.8 percent to 6.2 percent. Moreover, while the majority of the country's exports (around 54 percent) was classified as low-tech already in 1985, this share further increased over time, to reach close to 80 percent in 2006.]

⁶The principal countries are United Kingdom (7.1%), Germany (6.5%), France (4.4%) and Italy (4.1%).

- Transport and information communication technologies services] are, respectively, the most important types of services exported have been becoming more sophisticated since 2003. Potential for financial services, professional services, etc.
- Until the financial crisis, 2008-09, Pakistan had had a steady rising inflow of FDI, as a percentage of gross fixed capital formation. Inflows were relatively sizeable compared to other FDI has mainly come into the largely non-tradable sectors of banking and telecom.

22. Export Growth has been a mixed picture but below potential given the low trade to GDP ratio. Specifically,

- Pakistan exports have grown slightly above world's exports growth but much below that of exports of South Asian peers. In 30 years, Pakistan's exports grew 10 fold as compared to the 25 fold increase for the rest of South Asia.
- In terms of export volumes (Intensive Margin-IM), performance has been irregular. Some years of very good performance have combined with a few years of low export growth, possibly reflecting developments in the macro-economic environment and in foreign demand
- Export growth spurts occurred like other sectors in Pakistan's experience growth spurts at the end of the 1980s coinciding with crises induced reforms in the early part of the 2000s. Recent suppressed demand has affected all sectors but food and agriculture has maintained a positive terms of trade impact.
- Growth has been highest in the extractive industries, metals, and chemicals machinery, and through the down turn, electronics and transportation equipment were buoyant as were extractive industries and food, beverages.

23. Diversification of exports across markets and products reduces the vulnerability of the country's export portfolio to partner-specific shocks and to extreme volatility in export prices. The recent global crisis has highlighted the critical importance of diversification in reducing the risks of volatility in global demand and explains why this topic is rising in the agenda of low-and middle-income countries.

- Geographically, the US and European market shares for Pakistan's exports fell by 9 percentage points (from 61 percent in 2000 to 54 percent in 2009) while there is a small increase in exports to the emerging bloc of Brazil, Russia, India and China (BRIC) as did Gulf countries. Gravity Model says Pakistan is under-exporting with the large and fast growing economies of the 21st century including Japan, Brazil, Russia, and of course India.
- In terms of products Pakistan is mildly diversified, more concentrated than China and Turkey, but less concentrated than other middle-low income countries. More worrisome, however, is that in almost a decade, the period 2000-2008, there was an increase in product concentration in many countries, including China, Malaysia, Bangladesh and Turkey, whereas Pakistan's index not only did not decrease but slightly increased.

24. Overall, Pakistan is broadly moving toward new products and markets; but the pace in terms of new products is slower than those of potential competitors.

- In terms of products, Pakistan's share of exports in products that the rest of the world also exports has declined slightly over the last ten years, but it appears to be moving towards new exports that are economically significant.
- In terms of market destinations, Pakistan's export share in countries it currently exports to has reduced slightly, but it has increased its reach to markets that cumulatively are larger relative to the world in 2008 than in 1998.

25. As in most other countries worldwide, Pakistan's exports are concentrated in the hands of a few large exporters. The bottom 80 percent of exporters accounted for only 5.3 percent of total export value in 2010, down from 7.7 percent in 2003. Specifically,

- Export entry and exit rates are lower than in peer countries but new entrants more than offset the loss in exports by exiting firms. Each year, anywhere between 16 and 37 percent of firms exit and another 19 to 37 percent enter. While at first sight there seems to be significant destruction and creation of exporters in the data, entry and exit rates are lower than in other middle-low income countries). Moreover, the net effect on the number of exporters seems to be marginal. This suggests that the number of exporters is not expanding any significantly over time. Yet, new exporters seem more effective than sunset exporters.
- Churning along the destination-country margin also generated positive export growth. By contrast, there is a more anaemic performance in terms of sector and product differentiation. Again, taking 2002/03 as the base year over the 2002-2010 period, existing firms were instrumental in exporting to new countries, and even while there was evidence of exits, the net effect on the export growth rate was positive.
- Sector and product churning over the 2002-2010 period, was overall not very significant, and it seems that on average exits outweighed entries.
- Usually a higher positive contribution to export growth along the sector/ product margins should be expected that along the firm margin, due to the higher fixed costs of entry into export than for expanding the product range. In Pakistan, the sector/ product margin of growth is underperforming.
- The rates of survival in Pakistan are not low, at least compared to a group of middle-low income countries, for which customs data at the firm level are also available. For instance, in one year, 43 percent of firms exit, and by year 7 only 24 percent survives. Still, compared with other countries Pakistan is more effective in keeping exporting firms in the market – at least in the short run.
- Dynamism was significantly reduced after 2004 and has still not recovered. On average, fewer firms entered and exited the export market since 2004. Similarly incumbent exporters

became more conservative over time in terms of export markets, sector and product experimentation. In short, entries and exits by new firms, existing firms in new countries, sectors and products, all fell over the second half of the past decade.

Box 1
Determinants of Export Growth
Econometric Results

Firm level information has allowed, the OLS correlation between export growth and some key outcomes analyzed in through the papers. The first is that Pakistan can maximize its chances of exporting by eliminating barriers to trade and by using trade policy to create the conditions that foster firm dynamism, experimentation and quality upgrading of their products.

Diversification is good for export growth. Diversification, be it in terms of firms, products or destinations is positively correlated to export growth, with an effect that is sizeable and significant. Pakistan has been quite successful in increasing its exports by having more firms starting exporting and by having more exporters entering new markets. The performance in terms of helping firms breaking into new sectors and products has however been less satisfactory.

Tariff Structure Complexity in destination markets is an obstacle to export growth. A 1% increase in tariff “complexity” in the destination country leads to a 13.2% decrease in export growth by Pakistani firms. We measure tariff complexity as the standard deviation at the (HS-4 digit) sector level of individual HS-6 digit MFN and applied tariffs.

Firm level exports are constrained by fixed costs associated with entering in the exporting activity. Econometric analysis on firm level export growth shows, for example, that a 1% change in the amount of impediments at the border implies a 16.7% change in a firm’s export growth. Trade impediments at the border have a sizeable and statistically negative effect on all the extensive margins of trade and as a result, impede resources to flow to the most productive firms, sectors and products.

Fluctuations in export growth are linked to developments in the global demand. Largely determined by external and market conditions, demand can explain an important share of fluctuations and cyclical patterns in the export performance. Amidst very uncertain and volatile conditions for global demand.

Pakistan Policy Framework - Trade Policy

26. Chapter III examines Pakistan’s trade policy, one of the key contributors to trade orientation and export growth. For the past two decades, uses as the primary tool for policy objectives, use of tariffs - statutory and regulatory, and exemptions of such, along with various types of export subsidies – in terms of finance, fiscal tax exemptions, as opposed to the more opaque quantitative restrictions and explicit licensing requirements. Clearly, periods of simplification and liberalization at the end of the 1980s and again at the end of the 1990s, have coincided with the soon to follow, growth spurts in trade, both in terms of the extensive as well as the intensive margin.

27. Beginning in the mid-1990, Pakistan embarked on period of multilateral and unilateral trade liberalization program that was noteworthy for its depth and coverage. The program reduced government intervention, lowered and simplified tariffs and abolished remaining quantitative

restrictions. This along with favorable macro-economic environment and complementary reforms contributed to the export and growth spurt, which continued through until the mid 2000s.

28. However, during the last seven years, Pakistan's policy framework has seen major policy reversal. With a limited, but effective bias toward policies of indigenization programs, Pakistan's trade policy became increasingly complex as it was now more susceptible to input from vested interests.

29. Complementing the policy reversal from Pakistan's open trade regime was an external and internal deterioration in the business environment, in part due to deficient economic governance and infrastructure services. New import substitution policies started being implemented; with the pace accelerating since the crisis in 2008 Trade policies have become increasingly oriented to provide extra protection to the processing margins of determined local products and producers.

30. Pakistan is now ranked as the sixth most protected economy in the world according to the Overall Trade Restrictiveness Index (OTRI). While the OTRI of Pakistan is still not higher than India at the 88th percentile of countries, it reflects an increased complexity of trade policy and the reversal of some of the early progress towards reforms. Pakistan's protection of the domestic market is the main determinant of the high OTRI.

31. Pakistan's institutional system of trade policy application now contains a strong administrative protections system. For example, the "Strategic Trade Policy Framework 2009-12" by the Ministry of Commerce, the National Tariff Commission (NTC,)the websites of the Engineering Development Board (EDB) he Ministry of Industry,-suggest that protection of domestic industries along with infant industry arguments through tariffs and other measures are integral parts of the Government's economic strategy. The Planning Commission's recent document envisions a system without such an approach to industrialization. The Planning Commission Government of Pakistan (2011) recommends that the way forward should include the re-establishment of the unilateral trade liberalization program.⁷

32. Reconciling the protectionist objectives with ad-hoc interventions while also aiming at streamlining its trade policy and pursuing greater openness, it is worth recalling that "customized" domestic protection entails important costs and risks.

- Public support will be distortive, going to industries with high costs and low productivity at the expense of more efficient industries.
- Schemes that grant protection increase scope for smuggling and under-invoicing. The cascading principle, evoked by many governmental documents, makes this likely especially for final goods.

⁷The Planning Commission Government of Pakistan (2011) the immediate abolishment of the present system of distortive duties; the maintenance of a neutral real exchange rate policy; the re-establishment of normal trade relations with India, and acceleration of already signed free trade agreements, notably with China and Malaysia. See Planning Commission Government of Pakistan (2011) "Pakistan: Framework for Economic Growth", pag.74.

- Domestic market protection achieved through tariff protection generates an anti-export bias. Since exporting firms do not have any benefit from domestic tariff policies.
- Protection increases the complexity of the tariff regime and associated information costs.

33. In particular, the ensuing approach of pursuing very precisely targeted protection measures have given rise to an increase in tariff complexity as the applied levels of protection have now diverged dramatically from customs duty rates for many products, given the range of untrackable exemptions plus the addition of regulatory duties (Box 2).

Box 2
Trade Policy in Pakistan
Increased Tariff Complexity

The deviation of applied tariff rates from official rates is based on an increasingly complex structure of tariffs, exemptions and refunds. Duty drawback and/or concessions due to free trade and other arrangements are to be expected and are featured in many countries' tariff policy. However, the contrast between MFN ad valorem rates and effective duties observed in Pakistan are even more dramatic than most.

The official schedule in 2009/2010 suggests that custom tariffs have 14 slabs or bands, ranging between 0 and 150 percent with 40 percent of tariffs at 5 percent or less in ad valorem terms.

Transportation (automotive sector) attracts the highest tariff levels, as high as 60 percent in some cases with peaks above 90 percent for a few products (19 at HS 6-digit level). A large segment of agricultural goods are taxed at 35 percent,¹ but the official MFN schedule-based average is much lower, i.e. around 15.9 percent. Meanwhile, the average tariff for industrial sector is around 13.2. Finally, about 45 percent of the official schedule displays low tariffs, ranging from 0 to 5 percent.

The applied schedule using customs data at the transactions level for 2009/2010 at the 8-digit level shows that Pakistan applied some 40 different rates.

Over 50 percent of the effective tariffs are either 5 percent or less in ad valorem terms, with more bands appearing at the upper end of the scale, creating a higher level of dispersion. In addition, at least 2 percent of transactions appear to levy a rate between zero and less than 2 percent ad-valorem, tantamount to "nuisance taxes". Nuisance taxes, while adding to the cost of business, increase the administrative burden of collecting them potentially outweighing the benefit to the government from marginal revenues.

34. Since 2007, protection doubled for many products, while others went down to zero for certain importers while in 2008, almost 400 products were subject to regulatory duties on top of customary duties. At the same time, tariffs were reduced in the inputs not produced by Pakistan which enhanced the escalation in the tariff regime and created a very heterogeneous system of effective protection. This complexity unweighted averages of MFN tariffs a poor benchmark for assessing Pakistani trade policy, particular as this statistic has been decreasing over time. Some specific characteristics of Pakistan's trade policy on the import tariff side.

- Official custom schedule suggests a systematic escalation of tariffs by stages of processing. Raw materials and inputs attract low tariffs while consumer goods are taxed higher - twice as high in many cases. This pattern is more prominent and dramatic in consumer durable goods.

- Tariff dispersion is exploded through duties and exemptions covering half of tariff lines. Local content requirements were dropped in 2006 for WTO compliance, in favor of a complex mix of regulatory duties and partial exemptions for inputs (see Box 3).
- Transparency and predictability were the other casualties of this approach. Regulatory duties and special duties issued by Statutory Regulatory Orders (SROs) are notified in the official Gazette, but not consolidated in any published format nor included in the tariff schedule.
- Regulatory duties climbed to as high as 100 percent, while special duties up to 35 percent, mostly applied to finished goods and consumer durable goods.

Box 3 **SRO Exemptions As A Trade Tool**

Exemptions and partial exemptions provided for industries under SRO regimes are a key source of deviation from MFN rates and a serious distortion in incentives since they are exemptions for inputs for specified firms or groups of firms.

Analysis of the level and structure of Pakistan's tariffs is complicated by SRO based exemptions and partial exemptions to tariffs, sales and other domestic taxes. Though provided on the FBR website, the complexity the SRO itself make it difficult to discern the applicable taxes and other measures imposed on individual tariff items, particularly when multiple SROs apply.

The most prominent set of SROs are 565(1)2006, 567(1) 2007 and 575(1) 2007, accounting for 23 percent of Pakistan's imports in 2009/2010). On average, firms or industries under these three SRO provisions received concessions up to about 11 percentage points from the statutory rates, applied non-uniformly across industries. The exemptions under SRO (565, 567 and 575) cover several sectors, including *chemicals, automotive, rubber and plastic industries* as well as the *agricultural* sector.

Almost half (44 percent) of all SROs provided exemptions to the *machinery and appliances* sector, which also accounted for a quarter of all regulatory duties (22 percent) - selectively applied to the finished goods segment of this sector. There is an additional scheme of exemptions for the automotive sector that discriminates by Original Equipment Manufacturer (OEM) versus After Sales part and is implemented under SRO 655 (1) and 656 (1) 2006, and SRO 693 (1) 2006.

A common feature of all SROs is that their within sector incidence varies considerably distorting the incentive structure and complicating an already complex tariff system. (e.g. *optical photography* and related products with a high technological and capital intensity content enjoy low effective protection while *footwear and head gear* have high effective protection rate)s. Accounting for preferential agreements, about 18 percent of applied tariff variability is caused by the use of exemptions, of which 11 percent are detected at the firm level.

35. Tariff escalation and schedule complexity results in effective rates of protection (ERP) are far greater than nominal rates. By taking into account protection on both outputs and inputs, ERPs provide a more accurate the representation of incentives protection of "value added." Showing the expected amplification of the escalation and reinforce the earlier assertion about the escalatory tariff

structure⁸ The outcomes also demonstrate that the tariff structure complexity - i.e. exemptions and regulatory duties, in some dimensions, reflects indigenization objectives in a number of manufacturing activities.

36. The pattern of protection in place in Pakistan discourages of high value-added products, new entry and innovative activities. Resources are pulled into value added activities with high effective protection, which tend to have low value-added goods, or low-value added production methods. As well, these sectors with higher effective protection tend to be less competitive; they typically are domestically oriented biasing not only production, but resource allocation against export competing sectors. As an example derived from product level ERP measurements, refrigerators, air-conditioners, and deep freezers, targets of indigenization programs, have effective protection rates between 65 percent and 150 percent, while cotton yarn, an export industry, has an ERP of 5 percent.

37. As a result of the first generation reforms in early 2000s, the use of quantitative restrictions, as protective devices, was reduced but measures to increase the protection of the domestic market has returned. In addition to the EDB-administered “Indigenization Program” described above - amounting to a *de facto* local content requirement - with its discretionary control over new entrants to the industry and discrimination against import of domestically-available materials. Given the tax on exports, authorities, have countered with a subsidy through two sources: export finance subsidies and fiscal subsidies.

Complementary Policy Issues –Scarcity, Governance and Logistics

38. Chapter IV examines three sets of domestic issues: (i) fundamental problems that are pre-requisites to doing anything else in the area of economic development. Macroeconomic stabilization and management, water scarcity and power shortages; (ii) key investment climate issues, covering infrastructure, governance and functioning of factor markets; and (iii) trade logistics.

39. *Fundamentals: Macro, Water and Power.* While other key problems—such as large macroeconomic imbalances, domestic political instability, domestic security concerns and regional tensions—have hampered Pakistan realizing greater gains from its trade reforms. It is also arguable Pakistan’s heavily distorted tax and tariff system, which includes price and other support schemes for selected agriculture commodities; concessionary financing and export oriented concessions for and textiles and clothing; and other schemes artificially incentivizing selected sectors perpetuated rigidity in industrial and agriculture markets as highlighted in World Bank (2006) and ADB (20068) reports and become evident in preceding discussions. They particularly point out rigidities in the land and labor markets said to have been a major constraints for greater growth and dynamism of the private sector.

⁸ i.e. Raw materials are free of import restrictions, intermediates with moderate ERPs and import substituting industries (beverages, tobacco, motor vehicles and accessories, and vegetable oils and fats) with very high effective protection rates. Services industries protection is mostly negative or infinity, owing to the fact that most services are non-tradable for now.

40. *Infrastructure, Economic Governance, and Factor Markets:* To sustain these goals over the medium term, a strong investment climate is needed and return to a strong growth path, deeper analysis and policy recommendations are made along the following four areas:

- *Removal of infrastructure constraints particularly in the energy sector.* The power sector's inadequacies have damaged manufacturing growth with supply constraints reaching a critical point. Unlike other areas where differences exist across size groups, sectors and geographic areas, there is universal agreement regarding the primacy of the power sector issues as an investment climate constraint. In addition, the notable improvements in telecoms and logistics remain undervalued by an aging and inefficient transport system.
- *Strengthened governance of market mechanisms.* Though improving in recent years, antiquated laws, regulatory compliance and red tape at various levels of government are still problematic, burdensome and costly. More importantly are areas related to corruption in business-government interface, property right protection and contract enforcement, speedier and more certain mechanism for corporate exit and elimination of biases in tax, labor, financial and energy pricing which hinder the incentive to grow and formalize.
- *Increased depth and improved functioning in labor, land and financial markets.* Though firms consider access to these factors less of an issue than other constraints such as electricity or governance, the analysis points to a low level equilibrium in these areas. In the case of labor markets, low skills are only a problem for the few firms which have an educated labor force. In finance, large established firms have access to standard relationship banking, but new entrants are shut out. Risk based or capital market products are non-existent.
- *Attention to firm level technology adaptation and the role of public private partnerships (PPPs) in spearheading progress.* The low level of technology used by Pakistan firms has at its core both demand and supply side issues. In addition to infrastructure, PPPs should be investigated, as applied to public goods in cluster development, environmental and social standards, technology upgrading and quality assurance. New, risk based financial products are also required to support entrepreneurship and innovation.

41. *Trade Facilitation and Logistics.* A good logistics system can play a decisive role for Pakistan to attain access to foreign markets at lower logistics costs. It also helps to bring new firms and new products to the markets by foster integration of domestic markets and helping to exploit new trends in intra-industry trade. By helping reducing trade costs, upgrading the quality of services, improving connectivity with foreign markets and moving upstream in the supply chain the trade facilitation and logistics system is the key to export diversification.

42. Pakistan has a core transport and logistics system and environment that support trade in various types of commodities of varying cost, time and reliability sensitivities, ranging from agricultural products to electrical and other manufactured products. However, based on the 2010 Logistics Performance Index (LPI) data, Pakistan's overall logistics performance was below that of

India and Bangladesh as well as below the global average of all countries. Moreover, the South Asia neighborhood as a region lagged behind most regions, only surpassing Sub-Saharan Africa.

43. In the main, the LPI data suggest that Pakistan's performance main weaknesses are in the areas of infrastructure, customs and logistics competence. Connectivity in Pakistan features great geographical disparities. Outside the system connecting specialized markets in the Karachi – Lahore-Islamabad—Sialkot-Peshawar, which is relatively well functioning, trade logistics services are generally of a poor quality, especially when compared to other countries of a similar level of income.

44. The national logistics hub in Pakistan is located in the south of the country. As one moves north and west of the country and away from the core national corridor, access to high quality infrastructure and services reduces. In the relatively lagging regions, exports of niche products such as fresh produce for instance, would be challenged without better connectivity between the remote areas and export gateway. Given the nature of some of the prospective export commodities, which have high volume to weight ratios and the distances involved, it would appear the key to improving domestic connectivity lies in developing multi-modal systems based on rail and consolidation of trade volumes.

- *Railways.* Presently Pakistan Railways plays a relatively limited role in the country's freight transport despite having a network that extends over much of the country. Despite almost eight thousand kilometers of broad gauge routes linking all the major centers as well as to the Iranian network, the railway market share continues to decline while there has been a leveling off in the volume of freight traffic.

Railway tariffs are part of the problem as they are based not so much on cost of providing the service but on broader objectives to allow trade in the various commodities. Different types of cargo are charged different amounts even if they may weigh the same and are transported over equivalent distances. The railways then make losses and have to be subsidized by the government which caused the rolling stock and general maintenance to deteriorate rapidly.

- *Roads and Trucking.* Road transport is the dominant mode of overland transport in Pakistan, accounting for more than 80 percent of cargo volumes shipped. Despite the poor condition of parts of the road network, Pakistan has the lowest road freight transport rates in the world. This is partly due to the structure of the industry. The majority of trucks on the roads are operated informally as small fleets and are old and highly fuel inefficient. As a result, low rates are obtained by keeping old fleets and overloading vehicles. Competition and high operating costs reduce margins for the industry and hamper efforts to modernize the fleet.

In recent years there have been some changes in the sector with the emergence of an increasing number of formal companies running large fleets, in excess of 50 vehicles. The largest fleet operator is the state controlled National Logistics Cell (NLC) which owns more than 1500 trucks. There has also been a change in the organization of the independent truckers as some of the larger road haulage companies have developed relationships with the

independent truck operators in which they contract for their service on a regular basis as a supplement to their own fleet.

In 2007 the Government of Pakistan drafted a trucking policy which it is now implementing. The policy is designed to complement the NCTIP and serve as the basis for modernizing the trucking sector. It contains several progressive provisions which, if realized would contribute to a higher quality of service from the trucking sector. Some of the key proposals in the policy are: (i) enhancing access to finance, (ii) central information depository for motor vehicle registration, and (iii) vehicle worthiness certification.

- *Air transport.*- Air transport is the second most important mode of transport for international shipments in Pakistan, but is mostly covered by international carriers. Of the almost thirty air carriers serving the country, only three are from Pakistan. Five international carriers provide 40 weekly scheduled all-cargo services in and out of Pakistan. Karachi, Lahore and Sialkot are the only cities with access to scheduled dedicated cargo services. There are many more exports than imports, most of them passing through the main airports of Islamabad, Lahore and Karachi. Using the total turnaround cost methodology, Pakistani airports strike as one of the most expensive in terms of landing charges.

Pakistan's role in the worldwide airline network structure is far from central, and might present only limited opportunities for transit traffic. Pakistan sits astride main air traffic routes connecting Europe and the Middle East with Southeast Asia and Australasia and given the preeminence of other hubs like Dubai and Bangkok, it seems unlikely for Pakistan to become a credible connecting hub in the short run, Its geographical location might eventually favor short and medium haul connections in South and Central Asia and the Middle East.

- *Ports.* More than 90 percent of Pakistan's international trade is transported by sea. Most of the trade traffic is through Karachi where there are two container terminals, the Karachi International Container Terminal (KICT) and Port Qasim. Of the two, KICT handles the most volumes. All major shipping lines provide services to either Karachi or Port Qasim. However, connections to Europe are indirect, with hubbing mostly through Salalah in Oman.

Across the developing world cargo stays long periods of time in ports while in Pakistan, the port authorities allow for up to 5 days of free storage time in the premises of the port. Therefore, recent statistics suggest cargo dwell time in Karachi is 7 days - much higher than the 2-3 days prevalent in most efficient ports in the world. Beyond the average duration of stationing in the port, it would be valuable to understand the distribution of the actual dwell terms to get a sense of the reliability of the system.

- *Customs.* Pakistan Customs has been implementing a modernization program for the past several years and include the use of the Harmonized Code, creation of a Single Administrative Document), and electronic submission and processing of declarations at the seaports and the major land borders. These improvements have allowed a significant reduction in clearance times and an increase in the collection of duties and taxes. The rate of

physical inspections has been reduced but remains higher than would apply with an effective system of risk management. Still, the decision regarding inspections is often based on informal payments with a typical clearance times for cargoes with proper documentation at two days for imports and one for exports.

The procedures for handling transit cargoes have been simplified but the time and procedures required for transit permits and inspections are neither transparent nor efficient. A Risk Management Unit in Customs has developed some risk profiles and is supposed to select the level of inspection applied for individual shipments but lacks a formal system of Authorized Economic Operators. X-ray scanning was introduced at QICT but only for exports to the US.

Preferential Trading Agreements

45. Chapter V looks at the exports benefit from gaining preferences in the large export markets despite the low tariff margins. Fewer than 42 percent of Pakistan's imports receive preferences but 84 percent of Pakistan's exports go to countries granting preferences to Pakistan, but with low preferential tariff margins. Only 0.3 percent of Pakistan's exports to the top 20 importers receive a preference margin of 10 percent or above, mainly in armaments and commodities, but 30 percent of exports have a preference margin between 0.1 and 2.5 percent.

46. Despite trade agreements, 83 percent of world trade takes place on a non-discriminatory, most favored nation basis. Half of world trade is subject to MFN zero-tariffs, while preferential trade agreements exempt the high MFN-tariff items from preferential treatment but continue at the MFN rate. Finally, preferences tend to fall on elastic goods, further reducing the efficacy of preferences. In conclusion, the scope for preferential market access is not optimistic in the near future.

47. Pakistan is pursuing a strategy of economic integration through preferential trade agreements and bilateral trade integration along with membership of multilateral preferential trade agreements reflecting more general global trends in trade policy. In the last two decades, the number of preferential trade agreements has increased four-fold, to around 300 agreements in 2011. Pakistan joined the South Asian Free Trade Agreement in 2006 since 2005 Pakistan has sought bilateral trade agreements with China, Iran, Malaysia, Mauritius and Sri Lanka. The attention to bilateral agreement also reflects public awareness that Pakistan under trades with the large and fast growing economies in the region, including India and China.

48. To test for trade creation and diversion, the standard gravity model demonstrates empirically Pakistan's great untapped potential for expanding its trade relations, both on the export and import side. As would be expected gravity estimations suggest that Pakistan's trade is more elastic to trade frictions and distance than the world average. In particular, the elasticity of Pakistan's trade to is about 30 percent higher than the world average. Not only sharing a border appears to be a trade cost for Pakistan's exports, but the overall effect is so important that it doubles the cost of distance and appears to represent an additional substantial burden to trade. As expected, from the model, trade with India is 40 percent below its predicted potential, while Pakistan is a missing market for India.

49. Significant trade creation effects may originate from agreements with China and Malaysia, due to the deeper nature of these agreements into areas beyond market access issues (Box 4). Analysis shows that deep PTAs had positive trade creation effects while. By contrast, shallower PTAs had a statistically not significant or weakly significant effects overall.

Table 4
Preferential Trade Arrangement with China
What Does It Mean?

The biggest impact would result the PTA with China, while tariff reduction in the framework of PTAs with Malaysia and India would have a smaller effects.

The PTA with China goes beyond market access in goods, and seeks a framework of trade and investment rules able to address the emergence of supply-chain production as a prominent mode of twenty-first century economic integration. Specifically, the PTA covers non-tariff measures, services and regulatory matters, including provisions regulating the mutual recognition of services suppliers and other technical barriers to trade, international property rights and the establishment of Chinese investment zones in Pakistan.

Meanwhile, full tariff liberalization with China would have sizeable negative implications for Pakistan's trade partners - imports from some East Asian countries, the EU-27 and the US would be affected negatively by hypothetical full tariff liberalization with China. The largest negative impact would be felt by Japan, while a handful of other East Asian countries (Korea, Thailand, and Indonesia) as well as those from the EU-27 and the US would also be affected negatively. Imports from the rest of trading partners would be marginally impacted.

50. The way forward in terms of preferential trade agreements should be to scale up the efforts use bi-lateral or multi-lateral PTAs to reduce domestic impediments and trade barriers in order for Pakistan to benefit from the geographical advantage of being in a high growth region. At the same time market access and deeper integration within the South Asia region, in particular with India will be the key for future growth. There should also be a conscious effort to develop the country as a regional hub for trade and logistics, by enhancing domestic connectivity, service trade and export opportunities. In this regard, developing logistics links to Pakistan's neighbors should be the priority.

Building Pakistan's Capacity for Trade and Domestic Policy Analysis

51. Recognizing the importance of global competitiveness and integration for growth and poverty reduction, the Ministry of Commerce (MOC) of Pakistan launched an initiative in 2007 to develop an institute capable of providing policy advice backed by high quality research and analysis. New leadership was set in place in July 2007 at the Foreign Trade Institute of Pakistan (FTIP) to transform what had essentially been the training institute for officers of the Commerce and Trade (C&T) Group occupation category of the federal civil service, into such an institute. A government change in March 2008 saw continued support for the FTIP restructuring, and a revamped institute, renamed the Pakistan Institute of Trade and Development (PITAD), was launched in January 2009.

52. In a short period, the FTIP/PITAD made significant strides in its transformation, exhibited dynamic growth and attempted to fill a void in a lackluster national research environment on competitiveness and integration. In the meantime, the Bank moved beyond a retail model of research

support to developing countries (where Bank staff provides research outputs) to one that included a wholesale model (where the Bank provides data and analytical tools so that researchers in developing countries are able to produce research themselves and develop home-grown solutions to policy problems).

53. In this context, and consistent with the South Asia Regional strategy and the country partnership strategy, Non- Lending Technical Lending Assistance (NLTA) was extended to Pakistan to support evidence-based policy making. The goal for PITAD was the provision of: (i) quick response, high quality policy analyses, (ii) effective monitoring and evaluation of trade-related policies and outcomes, and (iii) longer term research on trade and competitiveness to support research-based, proactive policy-making. The aims of the NLTA were to provide activities and advisory services to PITAD that aimed to primarily: (i) build its research capacity, and to a lesser extent, (ii) upgrade its training function, and (iii) coalesce and stimulate a disjointed trade research community under PITAD's leadership, thus boosting the research output of the wider community and promote policy discussion and debate.

54. Given discussions on client priorities and goals, as well as Bank project constraints, activities carried out under the NLTA in support of PITAD includes: (i) identification and prioritization of capacity needs, (ii) delivery of capacity building activities and (iii) designing strategies for implementation of capacity requirements. Specifically,

- Research advisory services were broad ranging and focused on reinforcing a strong foundation of fundamental skills as well as introducing frontier research topics and methodology.
- A detailed design for developing a trade database was submitted that would utilize hitherto insufficiently used national trade data, with the intention of eventually making it publicly available.
- Training activities were narrow in scope and included training on trade indicator analysis for PITAD and State Bank of Pakistan researchers (including exposure to the Bank's open data initiative, and delivering two lectures on the global recession, its trade impact and trade policy responses.
- Activities to achieve the goal of coalescing the trade community was first informed by an assessment of the state of the trade research and cooperation among the community, the organization of joint meetings with data producers and various players in the research community, and proposals to promote cooperation in a disjointed and sparse community.

55. Results of the activities are (i) the provision of the high-quality analytical outputs to the Commerce Department that informed policy-making, (ii) the launch of a working paper series by PITAD in 2011, on issues that are currently vital to Pakistan, and (iii) awareness by PITAD staff of new research findings, newly available data, new research methods and emerging issues. In

developing its outreach, PITAD has also initiated greater links with domestic data producing agencies in particular the Bureau of Statistics, as well as with regional research networks.

56. While much progress has been made by PITAD, the research capacity in Pakistan still needs to mature further. The progress at PITAD and results and outcomes it has facilitated mandates further support to the institution to raise the quality of its analysis, pursue policy monitoring and evaluation that would contribute to optimal policy adjustment and reform sustainability. The way forward identifies design and implementation strategies geared to (i) increase the quality and scope of analytical work by introducing new methodologies, topics and data; (ii) increase research productivity by developing systems to reduce fixed costs of analysis; and (iii) attract and keeping high quality research staff. It also discusses upgrading PITAD's training program and activities to catalyze the wider trade community.

Policy Recommendations

57. Pakistan's recent trade performance stagnated in recent years. Despite positive signs of exports dynamism, with substantial churning of firms, firms have not been successful in breaking into sectors and products able to deliver higher export growth. In addition, the performance has become poorer after 2004, well before the global financial crisis, and has still not recovered.

58. Amidst very uncertain and volatile conditions for global demand, Pakistan can maximize its chances of increasing domestic competitiveness and hence exports by creating the conditions that foster firm dynamism, experimentation and quality upgrading of their products and by eliminating domestic impediments and barriers to trade.

59. Diversification is critical to enhance export performance, be it in terms of firms, products or destinations. To achieve the objectives of more dynamic and diversified export base, Pakistan needs to take substantial measures to develop a competitive business environment and in eliminating barriers to export. This will have a clear impact in terms of lowering the entry costs for exporters and for firms to venture in new products and sectors by creating a level playing field for firms, promoting intra-industry competition, and creating a more transparent business environment. It is also likely to attract foreign direct investment.

60. In particular, the following policy actions are proposed:

- *Promoting intra-industry competition requires first and foremost the abolition of the present system of distortive regulatory duties and highly complex trade regulations.* This complexity creates uncertainty, reduces transparency, and reduces firm dynamism. In particular, "customized" domestic protection entails important costs and risks.
- *In the medium-term, a simplification of the tariff regime is recommended.* This would have important positive effects in the long run, with the transitory effects of adjustment in terms of output and employment limited to some sectors and a relatively small impact on tariff revenues.

- *Pursuing greater regional integration through deep agreements* This note also brought supporting evidence that Pakistan could achieve great advances in trade performance by that look beyond market access and improvement of the country's overall logistics system.
- *Accelerating the implementation of deep preferential trade agreements* s. Significant trade creation effects are likely to originate from the agreements with China and Malaysia, due to the deeper nature of these agreements and their coverage beyond market access issues.
- *Scale up efforts to benefit from the geographical advantage of being in a high growth region* The many domestic impediments and trade barriers have thus far prevented the countries from benefitting from high growth in the region. Opening up with India and facilitating deep forms of trade integration is necessary to benefit from the high growth rates of the neighbor.
- *Weaknesses in the logistics system also restrain Pakistan's competitiveness and exports.* By helping reducing trade costs, upgrading the quality of services, improving connectivity with foreign markets and moving upstream in the supply chain, a sound trade facilitation and logistics system is of great importance for the country.

Pakistan's overall logistics performance was below that of India and Bangladesh as well as below the global average of all countries and suffers from infrastructure, customs and logistics competence. Outside the core north-south corridor, trade logistics services are poor. In order to upgrade the quality and reliability of the logistics services, five areas of action are suggested:

- *Improving port performance* is critical to lowering logistics costs. The stated average is much higher than the 2-3 days that is prevalent in most efficient ports in the world.
- *Improving regulation of the trucking industry* is another crucial step. There are already a number of initiatives underway to address the problems of the road haulage sector. Overall, the trucking policy seems comprehensive and well founded. .
- *Developing the land transport links to Pakistan's neighbors, including India, should be the priority*, since this allows to develop a multi-modal system which connects the more remote north and north-west areas of the country to the well established national logistics hub located in the south.
- *Addressing domestic connectivity disparities to create trade opportunities* especially in fresh produces requires a holistic approach. Exploring dry ports and railway expansion within a logistics cluster based approach can lead to the expansion of exports of new products, specially fruits and vegetables.

61. Finally, *improving coordination is essential*. The majority of Pakistan's logistics providers are small-scale enterprises offering a limited range of services and competing on cost with relatively little consideration for reliability or value.

CHAPTER I: AN ECONOMY SHAPED BY CRISES

A. Introduction

1. To understand well the depth of Pakistan's current challenge in transforming the economy to one governed by well functioning markets, open and fair competition and participation in the global supply chain, a solid understanding of Pakistan's initial conditions is needed. Pakistan's economy—its structure, performance and prospects—has been shaped to a large extent by the impact of domestic, regional and international crises, that had little to do with economics but nevertheless left lasting marks. Crises, in fact, some of which had historical roots to times prior to independence, have characterized Pakistan's economic history more than any other single factor—much more so than characterize the development history of other aspiring middle-income countries. Many observers over the years, inside the country and outside, have expressed little hope that the economy would be able to withstand the many crises it faced. But it has; in some cases using crises as catalytic enablers for reform (such as in the early 1980s and 1990s), but usually muddling through to the next one based on a heavy injection of state intervention. In most cases these crises had a significant and enduring impact on the society, politics and ultimately the structure of the economy.

2. One of the key impacts left by the historical prevalence toward crisis and crisis management, is the sub-optimal structure of the economy, in terms of (i) concentration on low value added, resource intensive product mix, (ii) a relatively stagnant enterprise sector bifurcated into a few export oriented textile mills and garment producers, a few primary products, and (iii) many small establishments, somehow operating on the edge of formality and competition. As will be illustrated in later chapters, this structure of exports has been concentrated for a long time on low unit value, low technology products that are not growing in the world economy and have little technological spillovers of the type common to those integrated in the global supply chain. Moreover, the economy seems unable to adjust to the changing market conditions, without the new industry, without innovative gazelles and without technological advancements. Little creative destruction is allowed to take place so that resource allocation remains concentrated in traditional and dominant firms.

3. In setting the scene for the country's goal of diversifying the areas where Pakistan can compete in international trade—at home and abroad, the chapter provides historical underpinnings to some of the steep challenges Pakistan faces in overcoming its initial conditions due in large part to the particularly disadvantaged nature of the economy's structure which developed since independence, as will be described below. However, perhaps more importantly, the chapter discusses how Pakistan's volatile economic history has left it without the institutional structure necessary for the economy to make large adjustments when necessary, and therefore has forgone diversifying through participation in the world's rapidly growing supply chains. In doing so, the chapter highlights how security, State building and other political motives drove key aspects of the economy policy making and thus left the economy with these challenging initial conditions. Pakistan is a relatively new country with new institutions – and the severe political turmoil faced by its citizens prior to, during and since independence has prevented the proper formation and development of markets and institutions capable of participating in the world economy.

1. *The Perfect Storm Facing Pakistan*

4. The metaphor, “the perfect storm,” has been well applied to the current state of the country, an economy experiencing great macro and micro difficulties; a struggling attempt at sustained democracy following unfinished civilian governments and episodes of military rule, conflict between the military and the civilian leadership; and a breakdown in law order, particularly in the urban areas amidst intense ethnic rivalries in the country’s largest city and the rise of Islamic extremist forces waging a domestic war, particularly in the urban areas. The impact on the economy of the latest crisis is becoming apparent, with high interest rates crowding out domestic borrowing, power shortages causing severe production disruptions, and political uncertainty hindering expansion through investment, hiring and risk taking.

5. As will be discussed in detail below, Pakistan’s economy has never been fully free of crises that touched all features of the economic landscape. But each time, they are deeper and wider in scope due to the lasting impact of each and the cumulative effect of many. In 2012 the country came under intense pressure due to accusations of poor governance in the Federal Government as well as issues related to continuing deterioration in domestic security, uncertainty in the amount of development finance from donors; a running dispute with the senior judiciary; conflict between the civilian leadership and the military high command; and ethnic and gang warfare in Karachi that has claimed hundreds of lives. The cumulative impact has been crises management to avoid macroeconomic instability in the face of slow growth, a decline in private and public investment and shortages in vital production inputs such as electricity, gas and water.

2. *The Risk of Greater Inequality and Unrest*

6. In 2011, Pakistan’s GDP increased by 2.4 percent, following slow increases in the three previous years and made the 2008-11 the longest downturn in Pakistan’s torrid economic history. Income per head of the population increased by only 0.4 percent and given the sharp deterioration in income and wealth distribution, a good part of the increase was captured by the well-to-do, leaving the poor poorer. With one-third of the population already absolutely poor, the low rate of GDP growth would lead to the pool of poverty expanding at 10 percent a year. In addition, while earlier on the back of trends toward urbanization, the rise in the world prices of food items, means that the poor in the countryside have done better than those in the urban areas—particularly in the large cities—adding to turbulence and sometimes dangerous unrest the country’s major urban centers.

7. In terms of longer-term perspectives regarding inequality and stability, with the country constant political turmoil and security uncertainty, the Government has not been paying much attention to the longer-term needs of economic policymaking. In particular, the need to provide a growing economy to employ the country’s youth has been considered as a goal, but without great urgency, consistency and certainty. Pakistan today has one of the world’s youngest populations with the median age at 21 years. In other words, 90 million of the country’s 180 million people are below this age. As the youth in Pakistan watch the turmoil in the Arab world, concerns have been rising how the underemployed in the country can be brought in to formal employment so as to be part of the system rather than against it.

3. *Internal and External Finance*

8. The government is spending much more than what it is able to collect by way of taxes. In 2011, the tax-to-GDP ratio dropped to 8.6 percent, the lowest among all large developing countries.

But this decline was not matched by reduction in all overall government expenditures. Islamabad became more profligate; spending huge amounts on non-development activities. The share of public sector development expenditure declined to a bit more than 2 percent, the lowest in history. In real terms, expenditure per capita on such basic services as primary education and health care declined to the point where only a quarter of the population was reached by the public sector.

9. The other area of concern is external finance. Having pursued an import substitution strategy of economic growth for decades, Pakistan never made a serious effort to develop its export industry. Exports remain focused on cotton-based products. Much of the government's energy has been spent on increasing market shares for textiles in Europe and the United States. There it has run into competition from other poor countries. Some of these nations are designated as "less developed countries" and, therefore, have preferential access to the markets of rich nations. With exports not increasing as fast as the increase in international trade, Pakistan's share in world commerce has declined. With a growing trade deficit, Pakistan is now faced with a difficult external accounts situation

4. *Prospects for the Near Term*

10. After a significant improvement in balance of payments on account of large disbursements—about \$8 billion in 2009 and 2010 from the International Monetary Fund (IMF)—external deficits have moved into the danger zone. Pakistan has terminated its program with the Fund. It seems apparent that, without major adjustments, the downturn of the last four years will persist. The government in Islamabad, led by the Pakistan People's Party, is embroiled in disputes with the powerful military and with senior levels of an increasingly assertive judiciary. Relations with the United States have frayed and economic aid that was promised to be maintained at a level of \$1.5 billion a year over the five-year period between 2009 and 2014 has been stopped. The rate of increase in GDP may not be much more than 2 or 3 percent and another 6 to 7 million people will join the ranks of the poor.

5. *The Formative Crises in Pakistan*

11. Two examples of formative crises in the US and India underscore that the crisis-change nexus, though not unique to Pakistan, can leave very different marks on the histories of nations. In both cases, crises were catalysts for bold changes as leadership acted fearlessly and with imagination.

In the US, the New Deal policies adopted by the administration of President Franklin Delano Roosevelt in response to the Great Recession of the 1930s is an example a deep crisis reshaping an economy. A significant expansion of the economic role of the state in the economic safety net was one of the most lasting policies adopted at that time, including the creation of the Social Security system.

In India, the handling of the Indian foreign exchange crisis by then Finance Minister Manmohan Singh led to India's modern day policy framework. Faced with a severe balance of payments crisis in the Government reversed the decades-old economic model which placed the state on the commanding heights of the Indian economy⁹ in favor of a more open system. His action plan

⁹ The first generation of Indian rulers—in particular Jawaharlal Nehru, the country's first prime minister who governed from 1947 for 17 uninterrupted years established the "license raj" that put most investment decisions by the private sector in the hands of the bureaucracy. This kept the Indian economy pinned down to a rate of growth of between 3 and 3.5 percent.

aimed to dismantle all kinds of controls to which the economy had been subjected and in a wide sweep of his pen, unleashed the pent-up dynamism of the Indian entrepreneurs.¹⁰

12. Crises have indeed also been important features of Pakistan's history. Several of these have had profound consequences for the shape of the economy, the structure of its political system, and the way the country's citizens look at the world outside. In dealing with them, the policymakers of the day adopted approaches that left their mark on the development of the country. Crises were caused by different sets of circumstances, and have numbered into the double digits, depending on how one characterizes crises. For the purposes here, four crises are highlighted due to their very strong impact on the economic structure today.

Dividing Society: Before Pakistan emerged as an independent Muslim state, colonial rulers in British India became concerned that the economic system was putting the Muslims under considerable economic pressures, particularly in Muslim dominated areas. While the laws that were put on the books to protect the Muslim peasantry achieved the objective, there were unintended consequences of exacerbating the Muslim-non-Muslim divide and contributed to the mass movement of people in the months around the time of the carving out of a new Muslim state. Resettling refugees and social divide has become an enduring challenge for realizing the benefits of economic integration—nationally, regionally and internationally.

A Difficult Neighborhood: In the years immediately following the partition of India and the creation of Pakistan, the creation of a predominantly Muslim Pakistan and a predominately non-Muslim India led to potential conflict that surfaced the moment Pakistan was born. There was the perception among the first generations of Pakistani leaders that first administration in India was attempting to undo partition and fold back the newly created Muslim state into India. This perception was to become the basis of public policymaking in Pakistan for decades and led to a series of crises related to the emerging conflict with India—deeply affect the structure, direction and performance Pakistan's economy ever since.

State Dominance of the Economy: The ideological underpinnings of the administration in power was more important as the source of crises in India than was the case for Pakistan as for almost four decades, the Indian state was put on the commanding heights of the economy. However, in Pakistan two administrations devised and implemented economic policies based on ideology: socialism in the case of Prime Minister Zulfikar Ali Bhutto (1971-77) and Islam in the case of President Ziaul Haq (1977-88). While the changes were less substantive in the latter case, in the former case, the policies adopted had lasting adverse consequences.

Impact of Poor Governance: Two periods in Pakistan's history are relevant: the first in the decade following the birth of the country when there was enormous jockeying for power, no institutions to intermediate between contending political forces and the resulting political chaos and economic confusion. Pakistan was placed under military rule and a new economic model due to the differences

¹⁰ Much has been written on the unleashing of the Indian economy as result of the reforms undertaken by Manmohan Singh. There are those who believe that the revival of the Indian economy began with Singh's 1991 dismantling of the license raj. However, others date the resurgence to the reelection of Mrs. Indira Gandhi as prime minister in 1980. According to the economist Bishriupriya Gupta, "a consensus has emerged in the literature that, irrespective of the period considered, economic reforms [of 1991] do not indicate a structural break in India's economic growth. This happened a decade earlier. One of the more interesting accounts is by an Indian entrepreneur who lived through the license raj. See Das, Gurucharan. 2002. *India Unbound: The Social and Economic Revolution from Independence to the Global Information Age*, New York, Anchor, 2002.

among the newly empowered political forces.¹¹ Neither he nor his program survived and he was forced to resign. Poor governance of a similar type reappeared in 2008-12, causing an already bad economy to turn to crisis.

13. While crises have affected all aspects of life in Pakistan, the focus of this study will be on economics. It will investigate the consequences of some of the economic crises in Pakistan's exceptionally turbulent history since its birth on August 14, 1947. An investigation of these four different sets of crises will help shed light on how Pakistan got to where it is today, the challenges before policy makers given the initial conditions and the limited capacity in the economy for major changes. Therefore, the adoption of public policies should take long-term view as well as a more immediate perspective.

14. The choice of episodes in many ways is idiosyncratic. Other economic historians will select differently for good analytical reasons. For example the following episodes could have been chosen but were not for reasons of brevity and relevance:

- The decision by General Ayub Khan to move the capital from Karachi to Islamabad and its political and economic consequences was also a turning point.
- The encouragement given by the Zulfikar Ali Bhutto administration to the unemployed workers to migrate to the Middle East had many unanticipated consequences.
- Nationalization of educational institutions at the same time devastated public sector education contributed to another historical crisis in human resource development.
- Pakistan's failure to implement the structural policies, such as those embodied in IMF programs, have kept it dependent on large flows of external assistance from other sources.
- Close relations with the United States has had a strong impact throughout the economy and disruption in these relations, going forward can also have lasting and profound consequences.

15. The consequences of crises on Pakistan's economy require investigation on how episodes in Pakistan's history have affected the economy's structure, institutions and society. A few crises have had a profound and lasting effect on the Pakistani state and the structure of the Pakistani economy. If the crises are severe, they can lead to changes in the structures of the economy. If crises keep piling up as they have done in Pakistan, the cumulative impact can be considerable. The impact of repeated crises, in other words, can be enormous and long lasting. They can also limit the room for maneuver available to policymakers at any given time. It is therefore, necessary to factor in history in order to understand the initial conditions from which to develop a sustainable approach to economic development.

B. Crisis Number 1: Public Policy and the "Mussalman problem"

16. Pakistan's very creation was the result of the perception by growing segments of the Muslim population that they will be discriminated against by a government that would be made up largely of non-Muslims who will be in majority. When the British left in 1947 and handed over the reins of power to the successor states of India and Pakistan, about a third of the population was Muslim. While the British administration in India attempted to protect its Muslim subjects from what was

¹¹ Muhammad Ayub Khan, *Friends not Masters: A Political Autobiography*, London, Oxford University Press, 1967.

viewed as predatory behavior of the economically more powerful non-Muslim community, the result was the unintended consequence of exacerbating the Hindu-Muslim divide—described sometimes as the “Mussalman problem”.¹²

1. Famines in British India—An Inheritance of Transport and Irrigation

17. The British administration reacted to the recurrent famines in the late 19th and the early 20th centuries in the northeastern parts of the Indian sub-continent in a way that was to deeply affect the areas that were to become part of Pakistan.¹³ The famines had caused great human suffering and risked reuniting India against the British rule.¹⁴ As Royal Famine Commissions were set up to advise the colonial government, the decision was taken to increase the amount of food India itself produced—focusing on the supply side of the equation. One way to affect supply was to bring surface irrigation to the vast virgin lands in the Indus Basin plane and the British invested heavily in developing irrigation in central and south Punjab and north Sindh.¹⁵

18. Investment in the system of irrigation was accompanied by a number of other initiatives by the colonial administration to ensure that the surplus food that would get produced would be transported to the deficit areas, including an elaborate system of roads and railways to connect the Punjab and Sindh with the northeastern parts of British India. In building the road system the focus was on further developing the fabled Grand Truck Road built by Emperor Sher Shah Suri in the middle of the 16th century. The railway system on the other hand was an entirely new development. India was divided into several railway regions. The North Western Railway, for example, transported food surplus from the Punjab and Sindh to Bihar, Bengal and Orissa, the perennially food deficit areas of British India and also ensured that the colonial administration could quickly move troops to the restive north. The railway system served a third purpose by providing employment to the community of Anglo-Indians that had grown in size and were loyal to the British rule. Most senior positions in the railway systems and the department of telegraph—two areas where the British were anxious to protect their interests—went to the Anglo-Indians.

19. The British also strengthened the system of administration in the newly developed areas called the “colonies”. For this they relied on the members of the Indian Civil Service, the ICS, which many historians of colonial India have called the “steel frame” that held together the large geographic space over which the British ruled for almost a hundred years.¹⁶ The principal British administrator in the area was called the “deputy commissioner” whose main function was to collect revenues for the government from landowners and collecting taxes. However, the emphasis in the colony districts was to maintain law and order and provide security to the newly settled farmers, to oversee the movement of grain surpluses, to provide basic services such as primary health care and education to

¹² The term “the Mussalman problem” was used by the British administration to deal with the growing discontent of the Muslim population with what they considered to be their weakening economic and political positions.

¹³ See Shahid Javed Burki, *Pakistan under Bhutto, 1971-77*, London, Macmillan, 1980, and Shahid Javed Burki, *Pakistan: A Nation in the making*, Boulder, Colo.: Westview Press, 1986.

¹⁴ The British were still recovering from what they began to call the Indian Mutiny of 1857 and were anxious to avoid any developments that would once again excite and unite the citizenry against their rule.

¹⁵ There is a reasonably rich literature on the development of irrigation in the Punjab. See, for instance, Imran Ali, *The Punjab Under Imperialists*, Princeton, New Jersey, Princeton University Press, 1988 and Aloys Michel, *The Indus Rivers: A Study of the Effects of Partition*, New Haven, Conn.: Yale University Press, 1967.

¹⁶ See for instance the seminal, two volume, work of Philip Woodruff, *The Men Who Ruled India: The Founders*, and *The Men who Ruled India: The Guardians*, London, W.W. Norton, 1985.

the increasing population, and to keep close contact with the administrative headquarters in the capital city of Lahore.

20. The colonial government's response to famines in India, therefore had profound impact on the structure of the areas which would become the Pakistan economy. These areas were fully integrated with the larger Indian economy, becoming the granary of British India as well as the supplier of raw cotton to the textile mills in Bombay and Gujarat. Thus, at the time of the partition of British India in 1947, India was by far the most important trading partner for the new state of Pakistan, picking up the bulk of its exports and providing it with most of its imports.

21. This integration and the impressive infrastructure inheritance, including a developed system of surface irrigation and a well built road and railway systems were the direct consequences of the repeated famines in northeast British India and the public policy response to them. As a result, Pakistan in 1947 was well integrated economically and physically, laying the ground for another crisis, discussed below, which destroyed the close integration but left Pakistan unprepared to rebuild its economic ties.

2. *Communal tensions in British India—A Risking State Role in Agriculture*

22. It was strategically important for the British to maintain the loyalty of the Muslim community in the Punjab and as a result, the structure of the economy of the Indian province of the Punjab had strong communal undertones. The loyalty of this community towards the British rulers during the days of the 1857 mutiny had made it possible for the colonial power to reassert its authority over the rebels.¹⁷ When the British began to recruit Indians to the British Indian Army, the Punjab became a major supplier of foot soldiers with most coming from the Muslim and Sikh communities of the province's countryside.

23. While much of the peasantry in the area was either Muslim or Sikh significant agricultural services was in the hands of the Hindu community, including supply of seeds at the time of planting, storage and marketing of food surpluses and provision of credit. The growing indebtedness of the Muslim peasantry to the Hindu money-lenders was an area of concern for the British.¹⁸ The British administrators serving in the districts of the Punjab were convinced that the peasants and small landholders who were mostly Muslims and Sikhs were not benefiting as much from growth in agriculture that had followed the arrival of canal irrigation in the province. They believed the reason was that a significant increase in incomes was captured by the middlemen. This could be prevented by using all manners of controls: by determining who could trade, how trading should be done, where should trading take place, and what prices the traders could charge from the producers as well as consumers.

¹⁷ The role played by the soldiers recruited from the Punjab in suppressing the revolt against the British is discussed at some length John William Kaye, *A History of the Sepoy War, 1857-58*, London, W.H. Allen, 1880, and Eric Stokes, *The Peasant and the Raj: Studies in Agrarian Society and Peasant Rebellion in Colonial India*, Cambridge: Cambridge University Press, 1978.

¹⁸ This problem was brought to light by Sir Malcolm Darling who had served in various capacities in the Punjab and had acquired in-depth knowledge of the more important aspects of the sector of agriculture. Darling's book has gone through several printings, most recently as a part of the republication of several classics on colonial India. See Malcolm Darling, *Punjab Peasant in Prosperity and Debt*, Delhi, Manohar, 1977, reprint of the 4th edition.

24. Over time the British administration in the Punjab put on the books a number of laws that were written in response to a slowly building crisis—the increasing economic dominance of Muslim peasantry by non-Muslim moneylenders. A few examples are noteworthy:

In 1901 the colonial administration passed the Land Alienation Act to prevent transfer of collateralized land from the Muslim peasants to Hindu moneylenders by dividing the Punjab population into two socio-economic classes: agriculturalists and non-agriculturalists. This social engineering served to keep land in the hands of the Muslim and Sikh agriculturalists but sharpened and institutionalized the Hindu-Muslim divide.

In 1929, the British again used the legislative process to extend the reach of the state into the agricultural economy, through the Agricultural Marketing Act—the main purpose of which was to regulate the role of the middlemen in commerce, most of who belonged to the Hindu community.

25. While social reasons for these acts are long gone, the legislations remain on the books. For instance, the Punjab Agricultural Marketing Act has been amended several times, most recently in 2002 to bring it in line with the establishment of a new system of local government.¹⁹ The Marketing Act inhibiting the development of domestic commerce in Pakistan, in particular in the marketing of agricultural products.

26. Taking these two episodes together—public policy responses to recurrent famines and the fear that the Muslim peasantry would turn against the administration if it did not protect their social and economic assets—it is clear that at the time of independence Pakistan inherited an economy dominated by a state regulated agriculture sector that was developed to serve the strategic interests of the colonial rulers. Large agriculture surpluses were sent as food to the food-deficit areas in northeast India and as raw materials for the manufacturing sector in the country's western parts. This structure of the economy would have possibly continued had two developments not occurred, one on the eve of Pakistan's birth, the other a couple of years later.

3. *Ethnic Conflict of 1947*

27. The ethnic conflict that took place in the northern parts of British India after the colonial administration decided to leave the sub-continent in the hands of two successor states caused some 14 million people, as estimated by some, to move across the yet-to-be-fully defined border between northern India and West Pakistan.²⁰ As eight million Muslim refugees—about 10 percent of the Muslim population of British India—arrived from India to Pakistan while six million Hindus and Sikhs moved in the opposite direction. Of the Muslim refugees, around a quarter were from urban populations while the remaining came from rural districts of the Punjab.

28. There were basically two streams of refugees that flowed into Pakistan. Those from the urban areas of India went mostly to Karachi, the first capital of the state of Pakistan while those from the Indian Punjab went to the part of the province that became Pakistan. Those from the urban areas rightly believed—given the weight of the state in the modern parts of the economy—that there were better prospects for jobs in the government, which was to be located in Karachi. The people who had

¹⁹ The marketing act's scope remains wide. According to the act's Article 3, "government may, by notification, declare its intention of exercising control over the purchase and sale of such agricultural produce and in such area as may be specified by it in the notification." With the government's sword hanging on the heads of those who could invest in commerce linking the countryside with the urban areas, it is not surprising that that this sector remain underdeveloped.

²⁰ Shahid Javed Burki, *Pakistan under Bhutto, 1971-77*, London, Macmillan, 1980.

worked on the land in the Indian part of the Punjab on the other hand were able to settle on the land vacated by the Sikhs in the Pakistani part of the province.²¹

29. Resettlement of refugees on what came to be called “evacuee properties” had many significant consequences. On the one hand, it was a remarkably successful operation: it settled eight million people who had arrived into the country as virtually destitute having left their assets and possessions in India. On the other hand, the amount of discretion that was allowed the settlement officers operating at various levels bought in corrupt practices into the operation. This was to set the tone for future bouts of poor governance in the country.

30. The community of urban migrants had skills needed by the new state and their influence over policymaking outweighed their proportion in the population. However, as they did not have the political base to establish an important political position there was considerable turmoil with the leaders who had large following in the rural community and the constitution was delayed.²² Constant political wrangling was the main reason cited by General Ayub Khan behind his decision in 1958 to put Pakistan under martial law.²³

31. Political turmoil was not the only consequence of the ethnic conflicts and population movements that accompanied the partition of India. The new ruling establishment under the influence of the urban refugee community focused on building an urban economy and neglected Pakistan’s considerable agricultural potential for a decade and a half. While attempts were made to reverse the bias by the government headed by General Ayub Khan, the path had been set and was exacerbated by the next crisis—the dispute with India over the rate of exchange between the currencies of the two new sovereign states.

4. Conclusion

- State Intervention—particularly in agriculture
- Lack of tax collection
- Role of State as employer
- Good agriculture irrigation and
- Road network but underutilized due to neglect of agriculture
- Railways as employment

C. Crisis Number 2: Relations between India and the New State of Pakistan

32. Nothing has mattered more for Pakistan’s economic and political development than its relations with India. Pakistan today would be a very different place—economically, socially, culturally and politically—had there been a better relationship with India. At the beginning, it was

²¹ Shahid Javed Burki, *Pakistan: A Demographic Report*, Washington DC, Population Reference Bureau, 1993.

²² Khalid bin Sayeed, *Pakistan: The Formative Years*, London Oxford University Press, 1960.

²³ Mohammad Ayub Khan, *Friends not Masters: A Political Autobiography*, London, Oxford University Press, 1967.

not destined to be tension filled. Even Muhammad Ali Jinnah, Pakistan's founding father, did not believe the divide between the two nation-states would become so sharp and decisive.

33. However, actions taken and responses adopted by the countries' new leadership led to a distance between Pakistan and India that was notable in its pervasiveness and consistency. The first Indian government took actions that were viewed as hostile by neighboring Pakistan.

- India stopped the flow of electricity to Lahore, at that time Pakistan's largest city.
- India threatened to divert waters from the rivers that flowed from its territory to Pakistan. It had the canal head works to control the flow.
- New Delhi refused to accept Pakistan's decision to devalue its currency in 1949 and stopped all trade with its neighbors.

34. In the midst of all this, the new Pakistani government had to settle eight million refugees who had arrived from India in a population of 24 million, while managing the departure of six million Hindus and Sikhs from the country. When Pakistan took its first census in 1951, one out of four of its citizens was a refugee. The young state of Pakistan had arrived at the first of the many crossroads at which it was to stop many times in its tortuous journey.

1. India's Refusal to Release Foreign Funds Owed to Pakistan

35. India was a debtor country before the Second World War but a creditor country afterward. The enormous supply of men and materials from India for the war effort of the United Kingdom (UK) had built up sterling balances that stood at 1.2 trillion pounds.²⁴ After protracted discussions, before relinquishing its control of India, the U.K. had agreed to pay a part of this amount to the successor states of India and Pakistan. Pakistan's share in these balances was negotiated at 17 percent.

36. When Pakistan gained independence, it had no foreign currency to pay for the desperately needed imports and badly needed the release of the sterling balances. However, while the balances were transfer to India, the Pakistan share did not reach Pakistan. Although India promised to release the payments no immediate action was taken. It was later learned that the Government of India was holding back on the pretext that Pakistan would use it in prosecuting the war which was going on in Kashmir.²⁵

37. One major consequence of this payment crisis was that an impression was created among the first generation of leaders that India was determined to undo partition. Nehru had bitterly opposed the campaign to divide British India along communal lines and, convinced that the Muslim state was economically not viable; it would prudently seek readmission into the Indian Union.²⁶ It was in this context that Pakistan designed its India policy and in the process did its economy a great deal of harm. This episode along with several other Indian decisions persuaded the Pakistani leadership to reduce its reliance on India by detaching its economy from that of India's. While the strategy was implemented, the cost was high in terms of the Pakistani economy, society and political system.

²⁴ Chaudhri Muhammad Ali, *The Emergence of Pakistan*, New York, Columbia University Press, 1967, p. 97.

²⁵ Ibid.

²⁶ History would thus repeat itself. In 1904, the British had partitioned Bengal also on communal lines. It took them seven years to realize the folly of their move. The partition of Bengal was annulled in 1901.

2. *Indus Water Dispute*

38. As discussed above, the British Indian administration invested heavily in the development of a vast integrated irrigation system in the province of the Punjab and in the northern parts of Sindh to provide food grains to the food deficit areas in the northeast. When the line of partition was drawn separating Muslim parts of the province from non-Muslims ones, little attention was paid to the geography of the irrigation system. While the canal system was in Pakistan, the head works were left on the Indian side.

39. A formal agreement, called the “Standstill Agreement,” on water sharing was negotiated between India and Pakistan before power was transferred to these two successor states; India would not use the head works to disrupt the flow of water into Pakistan. However, actions in 1950 affected the supply of water to Lahore and the surrounding areas. Considered provocative, the Pakistani Government signaled that it would be prepared to go to war if the supply of water was disrupted. The result was the “Indus waters dispute” that lingered for a decade and a half and resolved by the signing of a treaty in 1960 with The World Bank serving as intermediary in the protracted negotiations that led to the drafting of the Indus Water Treaty.

40. The final agreement was reached when it was decided that the waters in the eastern rivers that were being used by the irrigation system in Pakistan would be replaced by giant “link canals” that transferred water between the rivers in Pakistan. This was an expensive proposition and could not be undertaken by Pakistan using its own resources. The World Bank established an Indus Water Replacement Fund and work was begun on what was to be one of the largest construction project ever undertaken in the developing part of the world.²⁷ The treaty has worked for more than half a century and survived open military conflicts as well as serious disputes over construction of water works. Treaty implementation and dispute resolution panels are still overseen by the World Bank.

3. *Fixing the Value of the Pakistani Rupee National Economic Sovereignty*

41. In 1949, the Sterling Area countries devalued their currencies against the American dollar. The adjustment was large, as much as 40 percent decline in value. Based on its own reading that raw jute export, its main foreign exchange earner, was price inelastic, Pakistan was the only country that decided not to change the value of its currency, delinking it from the Indian rupee. The devaluation of that magnitude was feared to be highly inflationary, in particular for the urban areas, an important constituency for the new political establishment. With no industry of its own, the country was dependent on imports for most consumer goods and their price would have gone up significantly.

42. The decision not to devalue was not acceptable to New Delhi and the Indians stopped trading with Pakistan. The trade war with India was to have profound long-term consequences for the Pakistani economy. To begin with, Pakistan lost its largest trading partner and one of the two most important destinations of Pakistani exports—the other being China—and the most important origin for its imports. The jolt delivered by the policymakers in India resulted in reorienting Pakistan’s pattern of trade. Over time the distant United States became Pakistan’s largest trading partner while a small proportion of trade formally crossed the border with India.

43. Pakistan was also pushed into rapid industrialization. This is it did by adopting a strategy that departed from the conventional development approach of that period. Led by India, most developing

²⁷ The Indus Water treaty is described in gripping detail by Aloys Michel in *The Indus Rivers: A Study of the Effects of Partition*, New Haven, Conn.: Yale University Press, 1967.

countries relied on the state to industrialize—“. . . putting the state on the commanding heights of its economy”, a phrase Jawharlal Nehru used, having borrowed it from Lenin, to underscore his economic philosophy. Pakistan, on the other hand used the state to provide the private sector with incentives—cheap credit, import licenses, infrastructure development by the state—to invest in industry, which responded by investing heavily in consumer goods industry. For several years the rate of growth in industrial output outpaced that of agriculture by a factor of six to seven. Though the sustainability may have been in question, the rapid industrial performance was interrupted by the next big crisis—the decision by the next Government to nationalize industry, finance and commerce.

4. Conclusion

- Delinking Indian and Pakistan economies
- Rapid Industrialization program based on fiscal and financial incentives.
- Incentives to Private Industry to Industrialize.

D. Crisis Number 3: The Ideological Shift in Public Policy

44. For most of the time in Pakistan’s economic history, pragmatism was the basis of policymaking with various administrations largely following the prevailing thinking on development at any given time. The men in uniform were inclined to leave economic matters in the hands of civilian bureaucrats—many of whom were trained in western universities or, as in the days of President Ayub Khan, worked in close association with foreign advisors,²⁸ often following development thinkers in the West. In that sense Zulfikar Ali Bhutto’s philosophy applied during the 1970s represented a fundamental departure from the normal way the Pakistani leadership managed the economy.

1. Socializing the Economy

45. After the military had suffered a humiliating defeat at the hands of the Indian army in December 1971, Zulfikar Ali Bhutto took over the reins of the government. After the civil war which was to break-up the country and the creation of the independent state of Bangladesh, Pakistan—or what was left of it after the departure of East Pakistan—turned to Bhutto to lead it towards a different future. He took over the administration and moved rapidly to cast Pakistan in the image envisaged by him and his political organization, Pakistan Peoples’ Party.²⁹

46. The economic program saw the socialization of the asset ownership and production systems as the answer to the problems it was believed Pakistan faced. In particular, it was claimed—even by the Chief Economist of the Planning Commission—that the significant rewards from the remarkable rate of growth during the “decade of development” were captured by a narrow elite, suggesting that 22 industrial and financial houses had benefitted the most. Notwithstanding serious flaws in the

²⁸ Advisors, including from Harvard University who worked for the Planning Commissions in East and West Pakistan, wrote important books on Pakistan’s development experience. See for instance, Gustav F. Papanek, *Pakistan’s Development: Social Goals and Private Incentives*, Cambridge, Mass.: Harvard University Press, 1967.

²⁹ See, Hasan Zaheer, *The Separation of East Pakistan: The Rise and Realization of Bengali Nationalism*, Karachi, Oxford University Press, 1997.

argument, the “22 families” became a potent slogan in the elections and contributed to the electoral triumph of Bhutto and the Pakistan People’s Party (PPP) in the 1970 poll.³⁰

47. Bhutto’s Government nationalized large enterprises in all modern sectors of the economy. followed by actions to bring under state control thousands of small agro-processing enterprises. In July 1976, the government unexpectedly took over about 3,000 four mills, with a total employment of 30,000 persons.³¹ The Bhutto regime also brought on the books laws for to provide better working environment and higher compensation to the workers in the modern sectors of the economy.

48. The private sector which had flourished for 25 years after independence was marginalized and the country’s standard of living declined. There was a severe slowdown in the pace of industrial output and private investment in the sector. The prime minister was overthrown by the military in July 1977 but the long term damage to the economy has been secured, as 35 years later, the role of the state in economic policy making has not been clarified.

2. Conclusion

- Loss of Market Institutions
- Financial Repression and Misallocation of Resources
- Mindset of private sector and labor regarding the paternal state
- Opportunities lost in the economy (Lost Decade)

E. Crisis Number 4: The Evolving Pattern of Governance

49. Good governance goes beyond corruption more generally, implying the distance between the government and the people it was meant to serve. It includes responsibility for providing public services to the citizenry and their quality and holding public servants accountable for their work. Responsibility, deliverability and accountability, therefore, are three important attributes of good governance. Samuel Huntington wrote a number of years ago, the feeling of relative deprivation becomes acute when the economy is growing rapidly but most of the incremental income is captured by narrow economic and political elites.³²

50. Equally, poor governance has many meanings. It means the indifference of those in power towards delivering the services people need; to ensure security for the lives and properties of the citizenry; to respect the rights of all minorities, ethnic as well as religious; to hold themselves accountable for their actions; to provide stability and continuity of policies; and to create an environment which leads people to develop confidence in their future.

51. Poor governance has a negative impact on economic performance; this is one reason why the rate of economic growth has stalled in Pakistan since the return of democracy in early 2008. It has contributed to

³⁰ The rise of the PPP and with it the political ascent of Zulfikar Ali Bhutto has attracted considerable academic interest. The most comprehensive account of the PPP and Bhutto phenomena is Philip E. Jones, *The Pakistan People’s Party: The Rise to Power*, Karachi, Oxford University Press, 2003.

³¹ Parvez Hasan, *My Life, My Country: Memoirs of a Pakistani Economist*, Lahore, Ferozesons, 2011, p. 377.

³² Samuel P. Huntington, Huntington, Samuel P. 2006. *Political Order in Changing Societies*, New Haven Conn., Yale University Press. In his book Huntington used Pakistan as one of his case studies.

Pakistan not achieving the rates of GDP growth attained by other large South Asian economies. In addition to poor governance a number of structural problems prevented the country from reaching its potential. Among these contributors to economic growth poor governance is one of the more important ones.

52. Political uncertainty and poor governance, came together from before the current Government and since. There are many indicators of the decline in the quality of governance. To take one, corruption: according to the 2011 report issued by the Berlin-based Transparency International, Pakistan ranks poorly on that score. It is close to the bottom in the organization's ranking of countries around the globe.

53. There are several measures a well-intentioned government could have adopted to improve the quality of governance. Of these four are of particular importance:

- an accountability system for public officials,
- government brought closer to the people,
- modernized legal and regulatory systems along with institutional enforcement, and
- autonomy, accountability and appropriateness to the judiciary.

1. The Ultimate Accountability - Transfer of Power to the People through Elections

54. In 2008 the reins of government were gradually transferred from the military to the elected representatives of the people. The transfer should have taken place after the elections held in February in which the PPP won the most seats but not the majority. Following the election, the economies worsened as the following events took place that substantially weakened political and economic governance in the country.

- A grand coalition that included both the PPP and the PML (N) formed a government at the center in Islamabad. But the coalition lasted for only two months.
- Once in power the new president was reluctant to relinquish the authority the presidency had accumulated under military rule. It took two years to bring back the parliamentary system of government, but the President circumvented it as head of the PPP.
- PPP leadership was able to keep the government by persuading two other large parties to stay on its side, in one case agreeing to autonomy to local governments led by elected officials called the Nazims which will further cloud the governance structure post 18th amendment.
- Forces of extremist Islam were signaling to those who were opposed to it by suggesting that they would use the weapon of assassinations to get their way. Governor Taseer of Shahbaz Bhatti, was assassinated a couple of months later on January 4, 2011 by a member of his security guard after he had issued a statement in defense of a Christian woman and urged other to take to the streets to protest against blasphemy laws.
- Rapid weakening of relations with the United States from the Raymond Davis affair, the Raid to Capture Bin Laden and the friendly fire incident in which American's erroneously killed 24 Pakistan soldiers.

- Confrontation with the Judiciary which has prosecuted the Prime Minister and overturned Government policies, even in the area of the economic sphere.

2. *Bringing Government Closer to the People*

55. There is hope that the reshaping of the structure of government following the passage of the 18th amendment to the constitution will improve the quality of governance by bringing the state closer to the people. But there is also anxiety that the devolution of so much authority to the provinces could cause disruption in a number of areas. There is a particular concern that unless the process of devolution is managed carefully it could result in the deterioration of public services to the poorer segments of the population.³³ To avoid this, devolution and experiences have to teach.

56. The first is that the organization of the government must not stop at the center or at the provinces and has to include local government. The country has engaged in constant experimentation and has tried half a dozen systems of local government over the last sixty years instead of keeping one in place and improving it at the margin. Though there was good substance in the Local Government Ordinance of 2001,³⁴ the 18th amendment neglects provision regarding the mode of authority and resources at the local level.

57. The second is the importance of institutions in helping economies to move forward. Pakistan has treated institutional development with callous indifference and even well functioning institutions to wither away. During transition periods, there was preference for the new instead of improving the established. This is a danger of the government restructuring required by the 18th amendment.

58. The third is to adopt holistic approaches rather than ad hoc and truncated methods for addressing critical problems. Social development and the services that would promote it are the most important areas for government's involvement. What is needed is a grand strategy that involves the participation of many people and many institutions. As the several miracles in East Asia have demonstrated passion shown by senior leadership can produce remarkable results.

3. *Institutional Governance*

59. Since 2008, the country has been limping through a period of political transition. The army had by then governed for 33 years out of the 61 years of independence but gave way to one consisting of elected representatives of the people. However, within a couple of months the country entered a period of political uncertainty that has lasted to this date, contributing to economic stress and the risks which kept away the potential investors.

60. And although, the quality of governance in Pakistan is relatively poor, contributing to a major economic downturn, this has not prevented the well-to-do from becoming rich, leaving the rest of the citizenry way behind. Political scientists from the days of Samuel P. Huntington have been emphasizing that relative deprivation—their term—can be a powerful sentiment for forcing political change. It has been deployed in Pakistan's torrid history for bringing about regime change as governments of President Ayub Khan and Prime Minister Zulfikar Ali Bhutto fell largely because people were unhappy with what they received from the establishment.

³³ Institute of Public Policy, State of the Economy: Devolution in Pakistan, April 2011.

³⁴ This was underscored by a study produced by the Institute of Public Policy that examined the working of the system. The research project was funded by the Government of Punjab. See Institute of Public Policy (2008) 'Strengthening the System of Local Government in Punjab', Lahore, 2008.

61. Some movement has taken place on the last two on the list, with accomplishments in modernizing the legal and regulatory systems to support a market economy. Some attempts were made to set up institutions of accountability, most recently by the administration headed by President Pervez Musharraf. The National Accountability Bureau, or NABA, was meant to “put the fear of God into the rich and powerful who had been looting the state”, Musharraf wrote later in his autobiography. “But as had happened so many times before, it too became politicized...certainly Pakistan is struggling with Governance issues large and small.”

4. Legal Systems

62. A legal system is as effective as the judiciary that administers it. Largely because of the support by the citizenry through the various civil society organizations, and the heavy involvement of the legal community—the “black coats” movement—during the waning days of the Musharraf regime, Pakistan’s judiciary at the senior levels has begun to provide comfort to the people. Pakistan’s policymakers have not fully grasped the importance of a well-functioning legal system for providing good governance. No significant attempts have been made since the founding of the country to reform the legal system so that it adequately addresses the varied needs of the citizenry. Dispute settlement and holding accountable those who break the law are two of the more important attributes of a good legal structure.

63. The Supreme Court, led by Justice Iftikar Chaudhry, had displayed independence that was unusual in the history of the senior courts in Pakistan. A tradition of acquiescence began in 1954 when the superior court then under the leadership of Chief Justice Mohammad Munir held Governor General Ghulam Muhammad’s dismissal of the Constituent Assembly to be within the scope of chief executive’s base of authority. The court used the doctrine of necessity as the justification of its decision. Since then, the “doctrine of necessity” has been used as a way of justifying the actions taken by authoritarian rulers to assume even greater executive authority or to acquire it. Accordingly, once an act by the chief executive has come to take its course it would be disruptive to go back to status quo ante. This way of dealing with authoritarianism as well as military coups became a legal tradition in Pakistan. The Chaudhry court seemed inclined to move away from this tradition by holding the executive accountable to the law of the land and issued a number of decisions that went against it the executive, included the decision to annul the privatization of the Karachi Steel Mill.

64. Though Chaudhry was reinstated by a “dissident bench” of the Supreme Court a few months after his first dismissal in March 2007, he was removed again in November 2007 when the country was put under a “state of emergency” and all judges in the superior courts who had shown some independence of the executive branch were removed. Even after Musharraf’s resignation in August 2008 and the election of Asif Ali Zardari to the presidency, Chaudhry and his dismissed colleagues to the Supreme Court were not returned until mid-March when pressure from the opposition forced the Government to do so. The black coat movement and the assertion by the Supreme Court of its authority has resulted in a profound change in public opinion about the standing of the judiciary and its role in political development.³⁵

65. The courts operating at these levels have begun to take a deep and increasing interest in the political and bureaucratic systems’ accountability. The current conflict between the Supreme Court and the PPP-led government in Islamabad is likely to be resolved in favor of the judiciary

³⁵ According to the economist S. Akbar Zaidi, “for a country which is notorious for not following the law, in any manifestation of its practices – constitutional, civic or corporate – we are now faced with a judicial invasion and an onslaught of lawyers and legal opinions in the public sphere”. A. Akbar Zaidi, “Judicial invasion”, *Dawn*, January 20, 2012, p. 7.

notwithstanding the resolution passed by the National Assembly on January 16, 2012 expressing confidence in democracy. An efficient and effective judicial system is an important part of the democratic structure, not separate from it.

5. Conclusion

66. The crises have impacted economic development in Pakistan by establishing difficult initial conditions, creating an environment of extreme uncertainty and due to the need for constant crises response, have prevented Pakistan from carrying out longer term structural reforms. The second was economic. The repeated swings between civilian and military rule meant the absence of continuity in the making of economic policy. In its almost six and half decades of history, Pakistan has dealt with many crises, of which four formative ones were discussed here.

67. In each case, policymakers of the day were able to put in place policies and programs that delivered the country out of difficulty for a period of time, but not without lasting impact. In particular, Pakistan was able to settle eight million refugees arriving from India with hope but with few economic assets. Later it dealt with a trade embargo when the first administration in the country's history refused to devalue the currency. The charged issue of water supply in Pakistan required a decade long negotiations leading to the Indus Water Treaty.

68. The crisis of governance has been one of the more serious problems for the economy. In 1958, the military marched into politics and stayed in charge for 11 years. It returned three more times and stayed for a total of 33 years. The few gaps in its rule were filled by some form of civilian governance. This political roller-coaster caused a failure in the construction of a durable system of governance. These policy swings did not produce an environment that would have provided comfort to the investors willing to commit their capital over the medium and long term. Different governments tried different economic models, leaving much confusion in the minds of those who was prepared to invest capital in the development of the economy. For example:

- In the 11 year period from 1947-1958, private enterprise ruled supreme. The state was present on the margin, willing to help but not to intervene and obstruct.
- The advent of the military rule led to the articulation of an industrial policy in which the state became an active partner.³⁶
- The government of Zulfikar Ali Bhutto nationalized all large industrial, financial and commercial enterprises and discouraged private enterprise.
- The military government (1977-88) that followed adjusted the balance between the state and private enterprise in favor of the latter but did not go far enough.
- In 1991, the leadership of Prime Minister Nawaz Sharif, made the state step back decisively, leaving space for private enterprise.

69. In the process, Pakistan was often confronted with a shortage of external finance, serious enough to push the country towards near-default on its foreign obligations. This happened several times in the late 1990s, and again in 2008. Each time Pakistan went to the IMF for help, it failed to

³⁶ For instance the governments headed by Ayub Khan allowed no more than 12,500 spindles in a mill to spread ownership of large amounts of capital, laying the basis for an inefficient textile industry that continues today.

implement the program. On the other hand, during periods of natural disasters in such as floods in the 1950s, a major earthquake in 2005, and floods again in 2010 and 2011, even weak governments were able to tackle the problems caused by these events, by mobilizing the resources available.

70. The current structure of the Pakistani economy and its relations with many countries in the region were shaped to a considerable extent by the past. The crises discussed in this chapter illustrate how history can contribute to a better appreciation of the way the Pakistani economy has evolved since the country's birth in 1947. History also helps to define the "path dependence" in which those making public policy must operate.³⁷ In order propose solutions, it is important to understand how the past may have contributed so that responses can be calibrated. This time, at the beginning of 2012, however, the country is dealing not with one or two or three crises but perhaps as many as a dozen and those in power have not been able to come up with an adequate public sector response. As the situation worsens, the lessons from the history of crisis management in the country are clear: the longer it waits the more difficult, painful and time consuming.

³⁷ "...often if something that seems normal or inevitable today began with a choice that made sense at a particular time in the past, but survived despite the eclipse of the justification for that choice." John McWhorter as quoted by David Brooks, "Tools for thinking", *The New York Times, Global Edition*, March 30, 2011, p.11.

CHAPTER II: COMPETITIVENESS AND TRADE OUTCOMES

A. Introduction

71. Given that most, if not all success stories in growth accelerations worldwide have an outward-looking strategy, Pakistan's growth strategy has typically, and currently includes an explicit policy goal of greater integration in the world economy. However, as described in Chapter I, the crisis management paradigm that has plagued Pakistan since independence has left Pakistan's economy with challenging initial conditions in terms of the economic structure and the ability to adjust rapidly changing market signals.

72. The under-performance in terms of the economy's trade orientation, particularly in light of its favorable geographic and natural endowments, has been well documented, particularly in recent years³⁸ and continues to remain a key characteristic of the Pakistan economic landscape. Moreover, the further decrease in the trade to GDP ratio during the last decade—a period of high growth in world trade—is a clear symptom of structural obstacles to greater global integration.

73. The analysis shows that despite some progress in diversifying markets and products, Pakistan continues to rely heavily on saturated, slow-growing Western markets in its few traditional sectors such as textiles and apparel along with strong positions in rice and cotton. There is declining level of sophistication of its exports as little upgrading has occurred to earn higher value per unit of export, even where Pakistan clearly has a comparative advantage. Because of internal problems with trade-related incentives, business environment, and governance, and years of external shocks, described in detail in Chapter I, Pakistan's export strategies have largely been ineffective as reflected by its overarching performance indicators.

74. But deeper analysis reveals positive signs in the country's trade performance as well showing positive areas to build upon. As Pakistan's private sector has typically show a strong resilience, and adaptation, there has been experimentation with new products while there is evidence that new firms have been entering foreign markets. A somewhat surprising but key finding of the chapter is that growth in new products and new markets was the main driver of the overall growth of exports during the period 2002-2007. There are also some positive signs in trade in services (although perhaps, not fully picked up in official statistics), which has acquired some momentum, possibly because it can override tangible, physical constraints faced by the goods sector and due to the often overlooked but highly dynamic sectors in the Information Technology (IT) servicing and development fields.

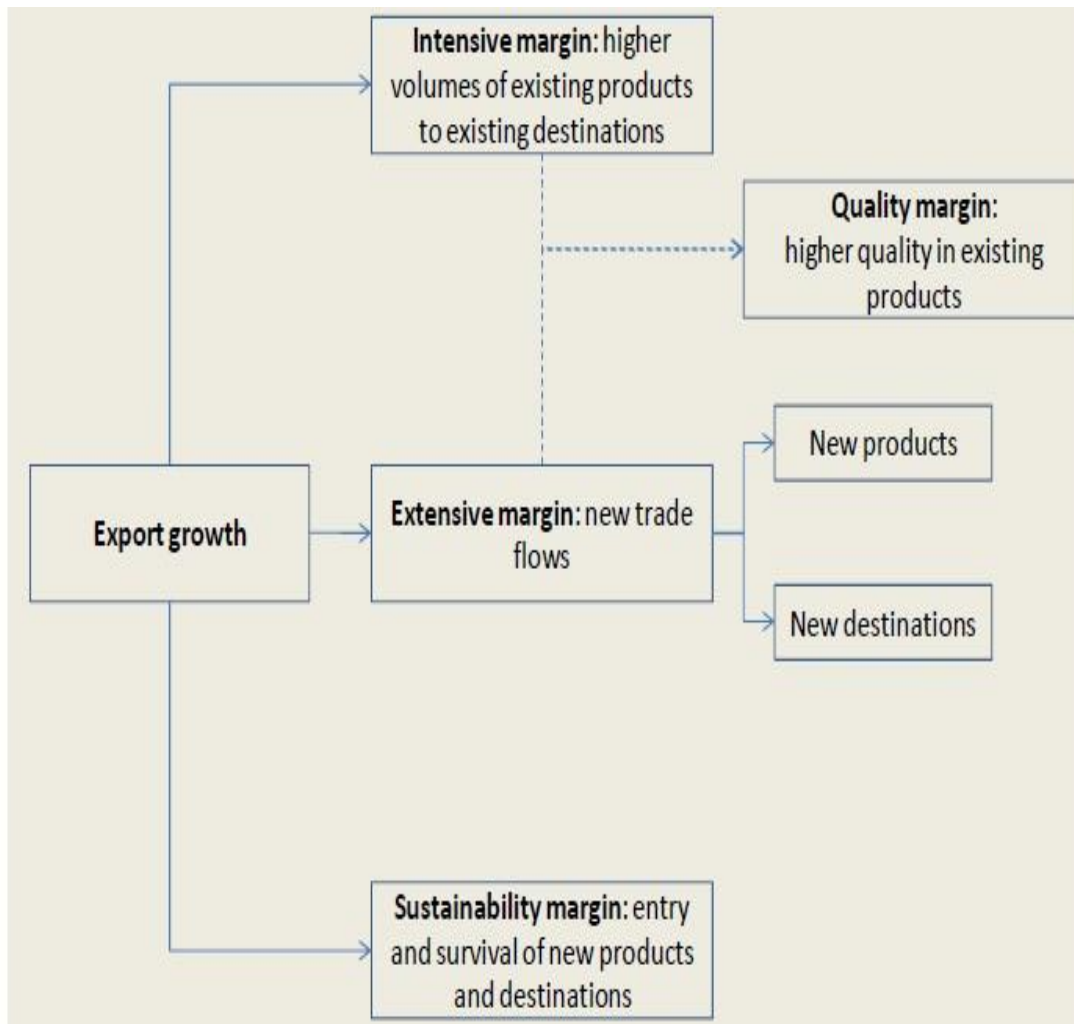
75. The comprehensive and detailed analysis of trade and specially exports performance over the 10 years which follows is intended to guide a systematic generation of hypotheses about Pakistan's export performance, prospects, and challenges.³⁹ As depicted in Figure 1, the framework for carrying out the analysis decomposes trade growth into four dimensions:

³⁸ World Bank 2007, Planning Commission, 2011, Manes 2010, Lahore University 2009.

³⁹ The principal source for the analysis is the UN COMTRADE database available through the World Integrated Trade Solutions (WITS) platform for the entry and survival analysis (sustainability margin) firm-level data was used, based on a customs transactions database for the period 2001-2010. Performance of Pakistan's exports is compared to a number of "peer" countries, selected based on factors including: location, similarity in country characteristics (level of income, size, geography, sectoral structure), and their presence as competitors to Pakistan's exporters in key markets. Peer countries for comparison using aggregate flows are China, India, Indonesia, and Vietnam. For the firm level data, middle income countries such as Bulgaria, Colombia, Peru and South Africa are used as comparators.

- Intensive Margin: level, growth, and market share performance of existing exports
- Extensive Margin: diversification of products and markets
- Quality Margin: Technology, quality and sophistication of exports
- Sustainability Margin: Entry and survival of new exporters

Figure 1. Measuring Trade Competitiveness A Conceptual Framework



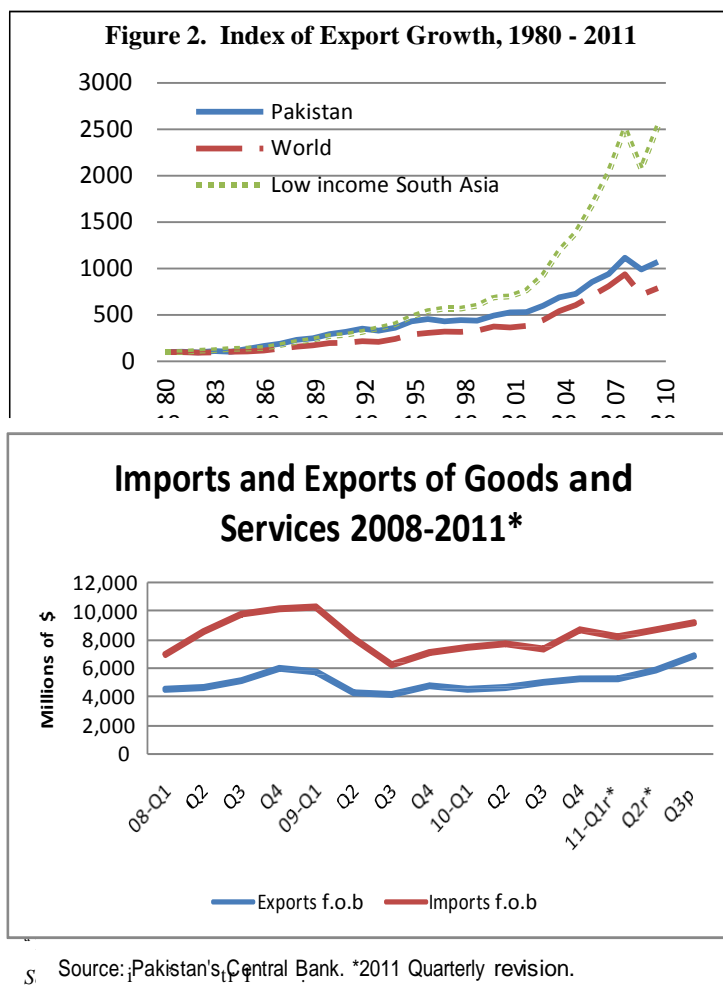
Source: Authors, derived from Cadot et al (2011).

76. This chapter is divided according to two types of analysis. The first examines aggregate trade flows to analyze growth, market shares, diversification and sophistication and compares these indicators with peer countries to gauge performance at the national level. The second part of the chapter considers analysis at the firm level to assess entry, exit and survival of companies attempting to enter the export market. Finally, an econometric exercise is carried out to underscore factors which determine export performance in Pakistan as a basis for the chapter's conclusions.

B. Growth, Diversification and Sophistication

1. Orientation and Growth

77. With a positive but subdued export growth over the past decade, Pakistan has recently suffered from a drop in demand associated with the current industrialized countries' debt and economic crisis. Pakistan's exports have grown in the last 30 years above world's exports growth but much below the accumulated growth of exports of South Asian peers (Figure 2). Specifically, Pakistan's exports grew 10-fold in 30 years, much less than the 25-fold growth observed in the rest of South Asia. During this period of time, the most intense growth of Pakistan's exports was observed at the end of the 1980s and at beginning of the 1990s. The most recent period, however, is associated with a deceleration of export growth. The contraction of both exports and imports during the financial crisis took place at the same time as the recovery of both flows that started in the third quarter of 2009 with exports growing slightly faster than imports, led by rice, textiles like men's shirts of cotton, women's apparel, petroleum oil and bed and bathroom linen, as well as cotton yarn.



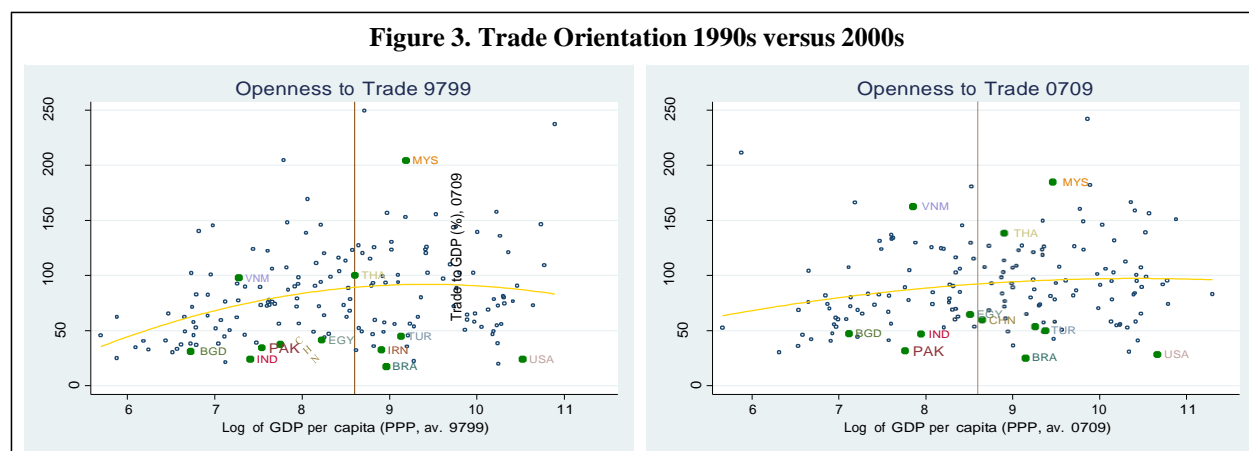
2. Openness to Trade

78. Pakistan's recent trade orientation is one of stagnation, as indicated by a decrease in its trade-to-GDP ratio over the last decade. At the same time peer countries have leapfrogged with high growth rates.⁴⁰ Pakistan's position below the predicted line indicates that it "under-trades" by half compared to countries at comparable levels of per-capita income.⁴¹ This is the case for all other populous countries it is compared with (Figure 3). Pakistan's average trade-to-GDP ratio for the period 2007-09 was smaller than what it was a decade earlier (1997-99), in contrast to the shares of

⁴⁰ The trade-to-GDP ratio is a basic indicator of global economic integration and gives an indication of the dependence of domestic producers on foreign demand and of domestic consumers and producers on foreign supply. Theoretically and empirically, there is traditionally a concave relationship between trade openness and per capita income: countries tend to trade more as incomes rise, but at a decreasing rate.

⁴¹ An OLS regression (using cross-country data from WDI) of trade/GDP on the log of per capita income (Purchasing Power Parity (PPP) current \$), its squared value, cost of exporting (using Doing Business indicator 2008-2010) and population, gives a predicted trade share of 65 percent as compared with the actual trade share of less than 32 percent.

its peers. In 1997-99, Pakistan's trade-to-GDP ratio was as high as China's, and much higher than India's. Ten years later, shares of both China and India almost doubled while Pakistan's fell.



3. Composition of Exports

79. From a sector point of view⁴², Pakistan's exports are dominated by labor-intensive light manufacturing—textiles, clothing, footwear and leather. This group's share in exports in 2007-09 was 65 percent. The second most important export sector was the agrifood sector with slightly more than 11 percent of total exports. Despite the geo-political and security difficulties posed by the war on terror, all sectors of Pakistani exports appear to have seen a healthy growth during the period 1999-2007. Almost all sectors experienced double-digit annual export growth, with extractive industries, metals, and chemicals growing above 20 percentage points annually. During 2007-09, years coinciding with the financial crisis, however, the manufacturing sectors, especially the textiles and apparel industries saw a drop in demand and annual growth was much slower in all sectors except machinery, electronics and transportation equipment, possibly partly sustained by the vitality of the electronics sector globally.

80. One of Pakistan main challenges is the lack of product diversification indicated by the fact that 10 products (4-digit Harmonized System (HS)) represent half of Pakistan's exports each year during the last decade.

Table 1. Composition and Growth of Exports by Sector, 1997-99 and 2007-09

Textiles, apparel, leather,	5,860,275	81.25	11,400,000	65.44	9.16	-3.05	9.77	11.59	
Agriculture, dairy, seafood	5,301,82	7.35	1,980,391	11.38	10.94	3.45	2.86	1.89	
Extractive industries	106,941	1.48	1,650,572	9.49	30.58	20.63	0.18	0.42	
Other manufacturing	315,141	4.37	739,045	4.25	11.22	-1.34	0.63	0.74	
Iron, steel, other metals	68,640	0.95	552,095	3.17	26.89	-1.55	0.16	0.36	
Food, beverages, tobacco,	227,851	3.16	455,360	2.62	3.24	19.40	0.47	0.49	
Chemicals, plastics, rubber	42,172	0.58	394,995	2.27	20.32	11.49	0.08	0.20	
Machines, electronics, equipment	61,309	0.85	227,942	1.31	11.37	14.10	0.04	0.06	

⁴² The sectoral classification follows Hanson (2010). Export values reflect mirror data in Comtrade.

81. Top Pakistan's exports products are the ones in which the country has a revealed comparative advantage (RCA),⁴³ like textiles, apparel, leather, footwear, agriculture products, meat and dairy and seafood (Table 1). For rising products such as mineral, metals and machineries and electrics, the country has no comparative advantage in relation to the rest of the world. The export growth of these products is reflected though in increasing values of RCA. In section 3.3 there is a further analysis relating sectors and revealed comparative advantage.

82. Geographically, the EU and the US represent the most important destinations of Pakistan's exports. The US and European markets absorb 31 percent and 23 percent of Pakistan's total exports respectively. China represents the third most important destinations, with an 11.5 percent share. Afghanistan, Oman, Turkey, and the United Arab Emirates (UAE) have recently become important destinations. A key theme in the later part of the chapter is how Pakistan is under trading with its neighbors according to economic indicators such as distance, income per capita, etc. Reasons for this were discussed in Chapter I, but will be address in the later part of the chapter from a trade lens.

Table 2. Selected Economies Market
Composition of Exports, 2009

EU	4,416,240	31.1	10.3	-7.3
USA	3,345,885	23.6	7.3	-6.4
China	1,632,546	11.5	7.5	-3.1
Brazil-Russia-India	558,617	4.1	21.1	1.0
Turkey	618,949	4.4	30.6	7.9
Rest of World	3,596,671	25.3	13.7	-9.8
Total	14,198,908	100.0	10.7	-6.3

4. *Diversification and Concentration Indices*

83. Diversifying exports across markets and products reduces the country's balance of payments exposure to partner-specific shocks, volatility in export prices or various other commodity-specify shocks. Chapter I demonstrates how Pakistan's many crises have highlighted the critical importance of diversification of the economy to mitigate the many shocks which come its way. Increasingly, services trade has become an important source of export diversification, in the world and will increasingly become so for Pakistan.⁴⁴

84. However, Pakistan's export bundle is relatively diversified in terms of products. Contrary to the macro level indicators and the prevailing perception among observers. The Herfindahl Index which measures concentration of export value at product and market level,⁴⁵ places Pakistan as one of the less concentrated among peer countries (Figure 4). During the current decade, Pakistan's index has increased, but the trend has also been observed in the majority of peer countries, such as Bangladesh, China, Malaysia, and Turkey.

85. As well, surprisingly, Pakistan has indeed diversified its destination. The prominence of US and European markets in Pakistan's exports reduced by about 9 percentage points, from 61 to 54 percent since

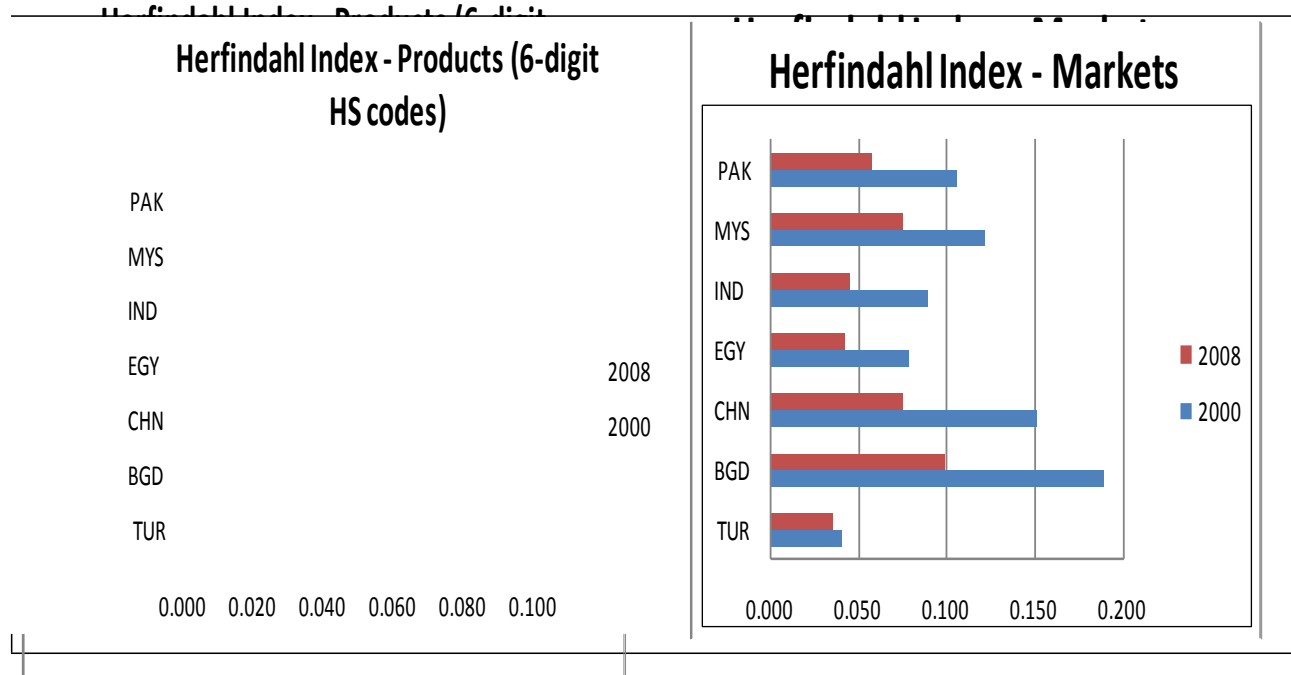
⁴³ The RCA index is one measure for calculating the relative advantage or disadvantage of a certain country in the trade flows for a certain industry. An index above one indicates the country's share of exports in that sector or product exceeds the global share.

⁴⁴ The World Bank Group Trade Strategy 20011-2021: Leveraging Trade for Development and Inclusive Growth.

⁴⁵ A diversified export portfolio will have an index close to zero. Export of one product or to one market will have an index with a value of closer to 1.

2000. Like other countries, there has been a small increase in exports to the emerging bloc of Brazil, Russia, India and China (BRIC) and Afghanistan, Oman, Turkey, and the UAE are more important destinations.

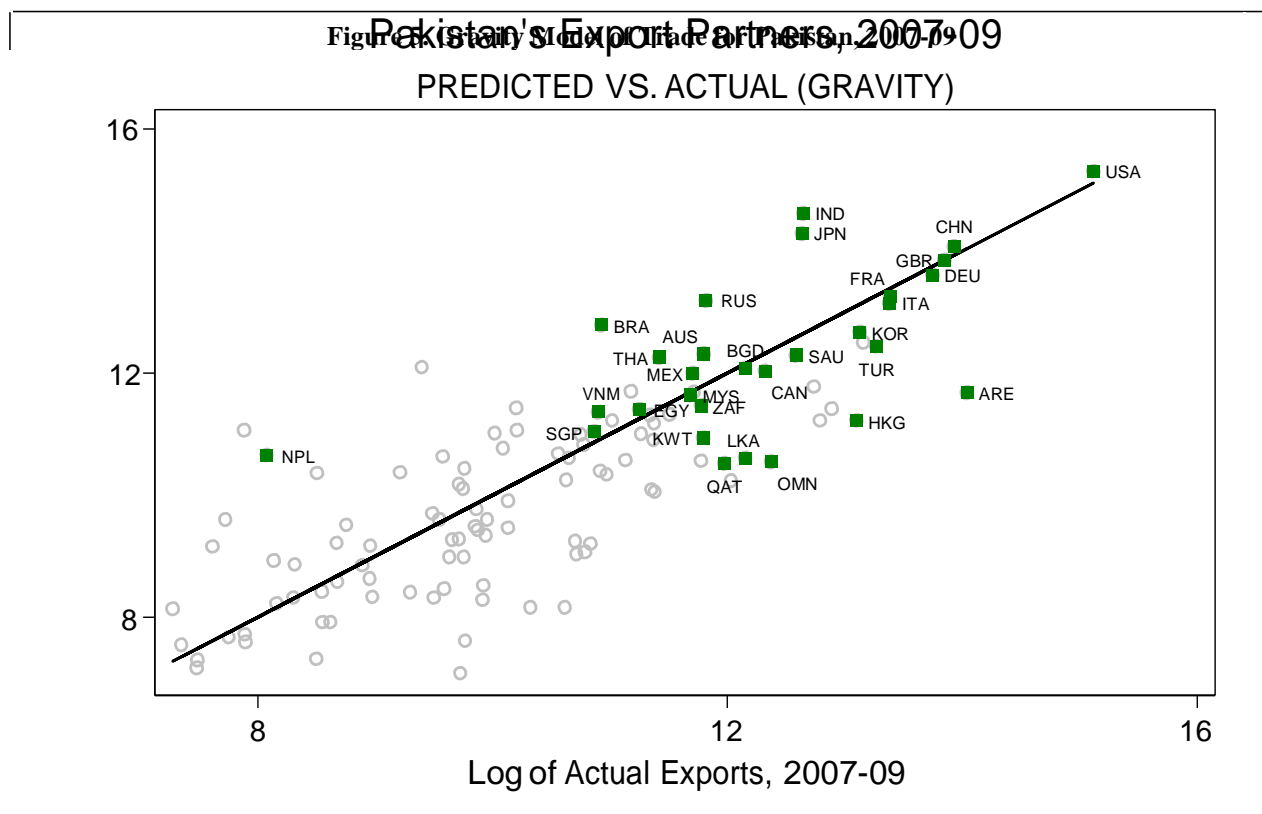
86. Despite this diversification of destinations in recent years, Pakistan's exports remain relatively more concentrated than peer countries. Pakistan's emphasis on industrialized countries export markets makes the country too vulnerable to economic developments in these countries and does not seem to fit within Pakistan's gravity model—one predictive method for trading partners.



5. Gravity Model Results

87. Deepening this recent trend is key, as Pakistan appears to be still under-exporting with large and fast growing economies - including Brazil, India, Japan and Russia - below what could be expected (above the 45-degree line in Figure 5) based on a gravity model of trade.⁴⁶ For example, Pakistan's exports to Sri Lanka have grown in response to a bilateral trade agreement in place and trades heavily with members of the Gulf Cooperation Council (GCC) as re-export points for trade with third countries.

⁴⁶ Bilateral exports are related to the bilateral characteristics of trading partners including, distance, contiguity, common language, colony, common colonial power, GDP, GDP per capita, etc. The model also incorporates three innovations: (i) a measure of remoteness to incorporate relative distances alongside absolute distances, (ii) control for zero trade flows so as to incorporate the information of zero flows, rather than dropping, and (iii) control for firm heterogeneity without using firm-level data by inferring features of marginal exporters from the export destinations.

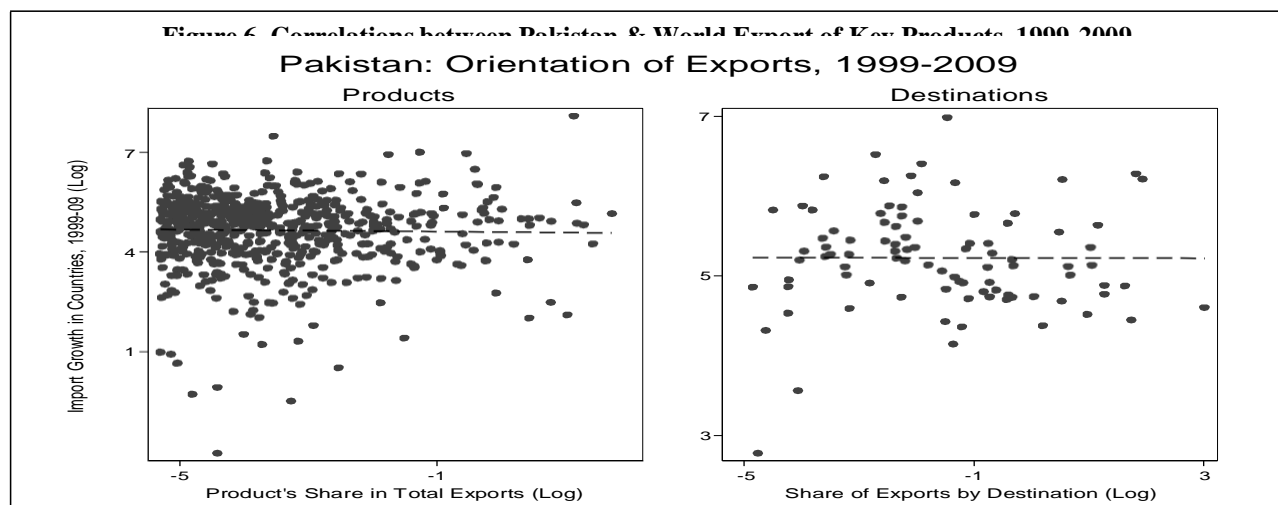


6. *Growth Orientation of Export Products and Markets*

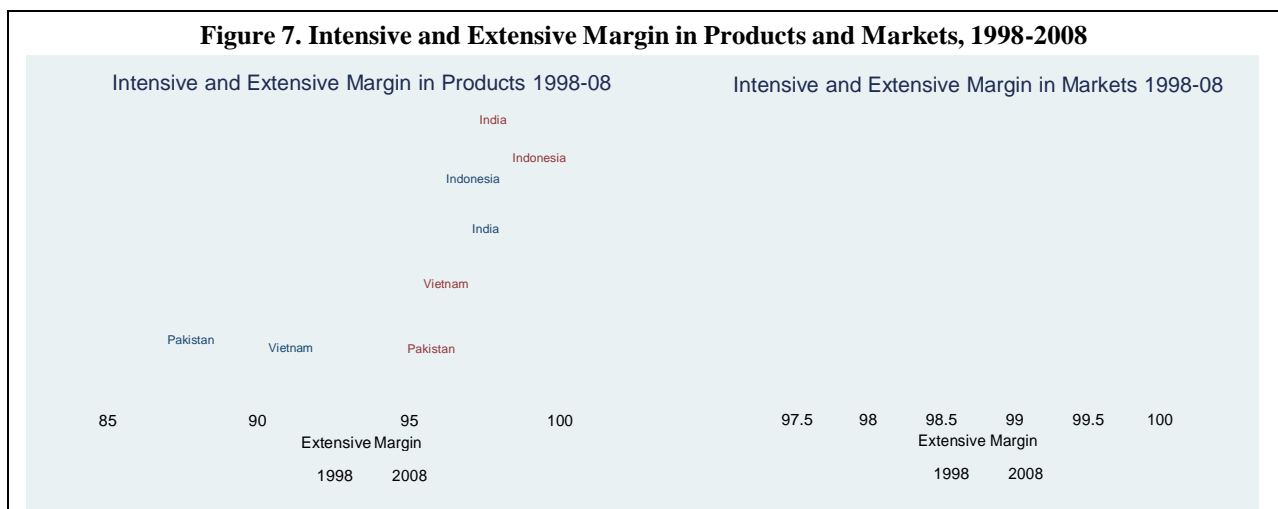
88. Optimally, exports in which Pakistan specializes should be those which are “pulled” by rapid world growth in the demand for the product. However, when examining Pakistan’s trade share in expanding strategic markets, little correlation exists between those products and the growth of Pakistan’s exports. In other words, Pakistan’s top export categories—cotton, apparel, leather—are not growing as rapidly as other products growing in the world market, such as fruits/grain/oil seeds, cereals, chemicals, plastics, etc. Similarly, apart from China and Turkey, Pakistan’s top export markets are not among those that have seen the highest rates of growth over the past decade.

89. Graphically, world growth is related to the importance of such high-growing products in a country’s export portfolio (Figure 6). A positive, upward-sloping relationship is desired as the highest export share products would be growing in world markets. For Pakistan however, the growth orientation of products is closer to flat showing a much lower correlation of Pakistan’s product’s shares of own exports with the world growth of these products as compared to China and Malaysia.⁴⁷

⁴⁷ The 6 digit HS product must represent at least 0.5 percent of total exports, and the export market must receive at least 0.5 percent of Pakistan’s total exports. With higher threshold both correlations become more adverse.



90. Still, at low levels of activity, there is evidence that Pakistan firms indeed moving to products and markets with greater opportunities, though much less so than potential competitors. The evidence at the aggregate level is that the intensive margin (IM) of exports has declined while the extensive margin (EM) has improved slightly. The indications are therefore, that Pakistan's has lost some share in products that the rest of the world also exports (IM) has declined slightly over the last ten years, but appears to be moving towards some new exports that are becoming economically significant (EM).⁴⁸ At the same time, Pakistan's export share in markets it currently exports to (IM) has reduced slightly, but it has increased its reach to markets that cumulatively are larger relative to the world in 2008 than in 1998 (EM) (Figure 7).



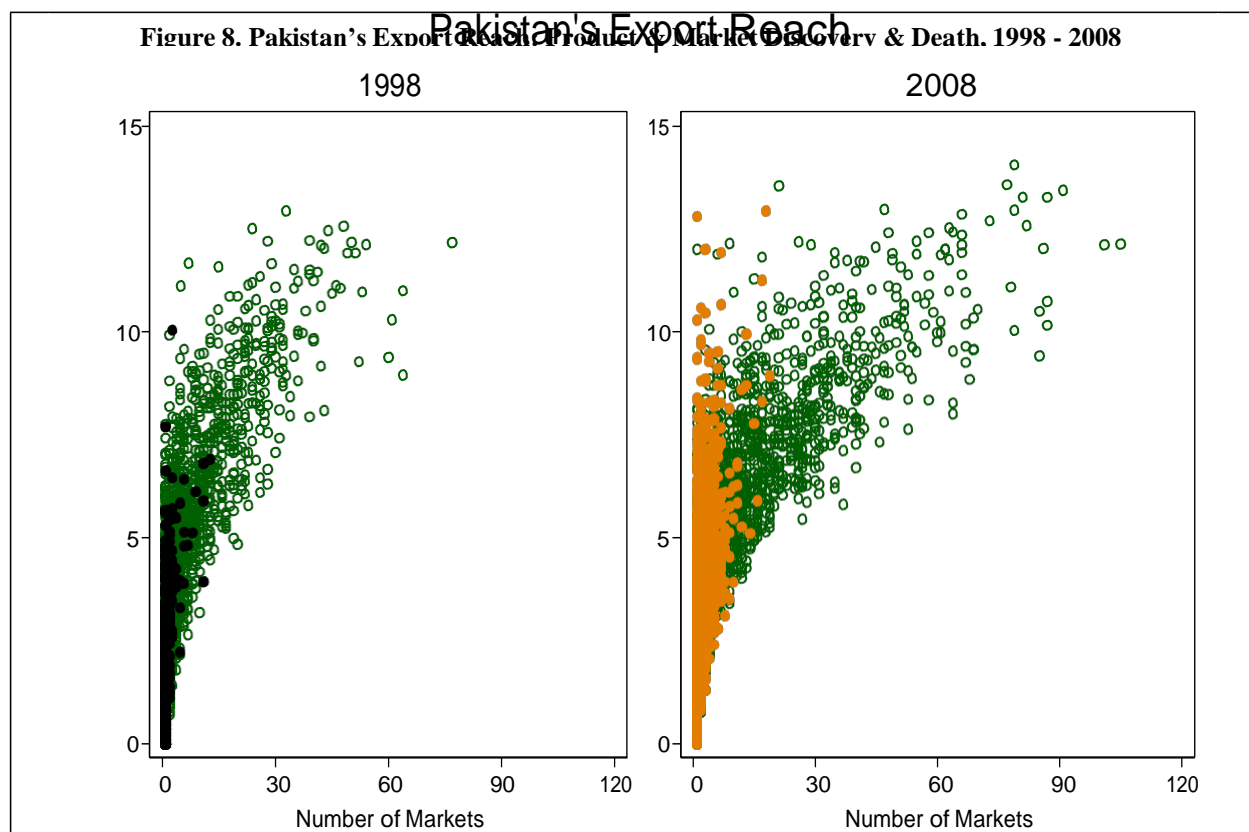
91. In comparison, countries such as India, Indonesia and Vietnam, however, have managed to increase their share of export in goods which the rest of the world produces too (IM) as well as the breadth of their export portfolio relative to all exportable products (EM). India and Vietnam have increased their existing share of exports to existing markets, but have not added new markets to their portfolio of destinations. Indonesia has done both.

⁴⁸ Following Hummels and Klenow (2005) The IM indicates how big is Pakistan in what it exports, and the EM measures how globally important is what it exports. "From a big fish in a small pond to a small fish in a big pond."

7. Value and Reach of Exports

92. Over the 10 year period, 1998-2008 Pakistan has expanded the number of export markets served from less than 80 to well over 110 (Figure 8).⁴⁹ The number of products in the newly expanded or existing markets has increased. Products that disappeared did not constitute large export amounts, whereas the possibly new exports in 2008 earned large amounts, with some already seen to reach around 25 markets.

93. Products that expanded their reach of markets include those in which Pakistan has a comparative advantage. Textiles and apparel are obvious, but a product that stands out for rapid expansion is *manicure/pedicure sets belonging to the surgical industry*, or products like *eye makeup, beauty make up, shampoos, medicaments or wedding and gauze with pharmaceutical substances*. There are new agricultural products growing, such as rice, or agro industry like *chewing gum, chocolates, biscuits, fruit juice and sauces*.⁵⁰

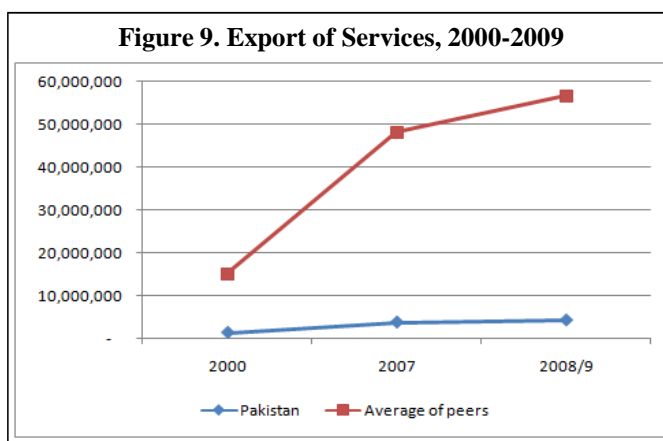


⁴⁹ Figure 8 shows products and markets with (i) existing products in 1998 and 2008 in green, (ii) products that were not exported in 1998 but were in 2008 in orange – as new discoveries, and (iii) products that were exported in 1998 but not in 2008 – as death or suspension in black.

⁵⁰ A visit to Sialkot provided the opportunity to meet exporters who were successfully exporting an expanding volume of surgical instruments all over the world, but mainly to the countries of the EU.

8. *Export of Services and FDI*

94. Trade in services, although picked up only partially in official statistics, has acquired some momentum, possibly because it can override tangible, physical constraints faced by the goods sector. Increasingly, services trade has also become an important source of export diversification⁵¹ but outside Bangladesh, Pakistan has the lowest share of services in GDP among its peers. In terms of services exports, Pakistan shows some growth, but less than that of its peer countries: Bangladesh, China, Egypt, India, Malaysia, and Turkey. Between 2000 and 2007, exports of commercial services grew at a compound annual rate of nearly 15 percent, which is just below the average rate of peer countries (Figure 9).



95. Transport and information communication technologies services are, respectively, the most important types of services exported (Table 3).

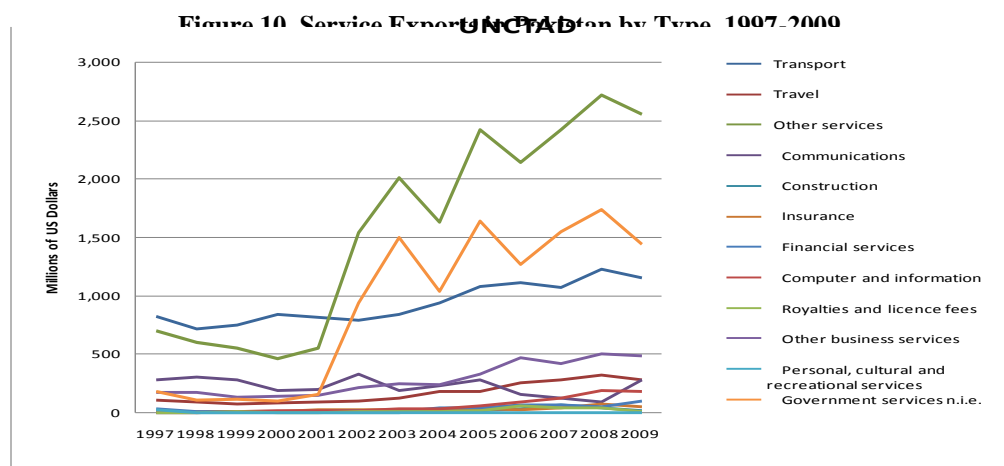
Table 3. Service Exports Share of Commercial Service Exports (%)

	2000	2007	2008/9	2000	2007
Insurance and financial services	1.2	4.6	5.0	21.7	1.2
Computer, communications and other services	27.1	34.9	34.0	3.7	-0.4
Transport services	65.4	48.0	48.5	-4.3	0.1
Travel services	6.3	12.4	12.5	10.2	0.1

^a Average value in 2008-09

Source: World Development Indicators (WDI) 2010.

96. The evolution of the services exports by category is shown below (Figure 10).



⁵¹ The World Bank Group Trade Strategy 20011-2021: Leveraging Trade for Development and Inclusive Growth.

97. Except for the years of the financial crisis, 2008-09, the recent past provided Pakistan with a steady inflow of FDI which was significant in the percentage of gross fixed capital formation. Inflows were relatively sizeable compared to other Asian economies (Table 4) with FDI coming mainly into the largely non-tradable sectors of banking and telecom. These two important backbone services gave a boost to the country's overall productivity, dynamics and therefore exports.⁵²

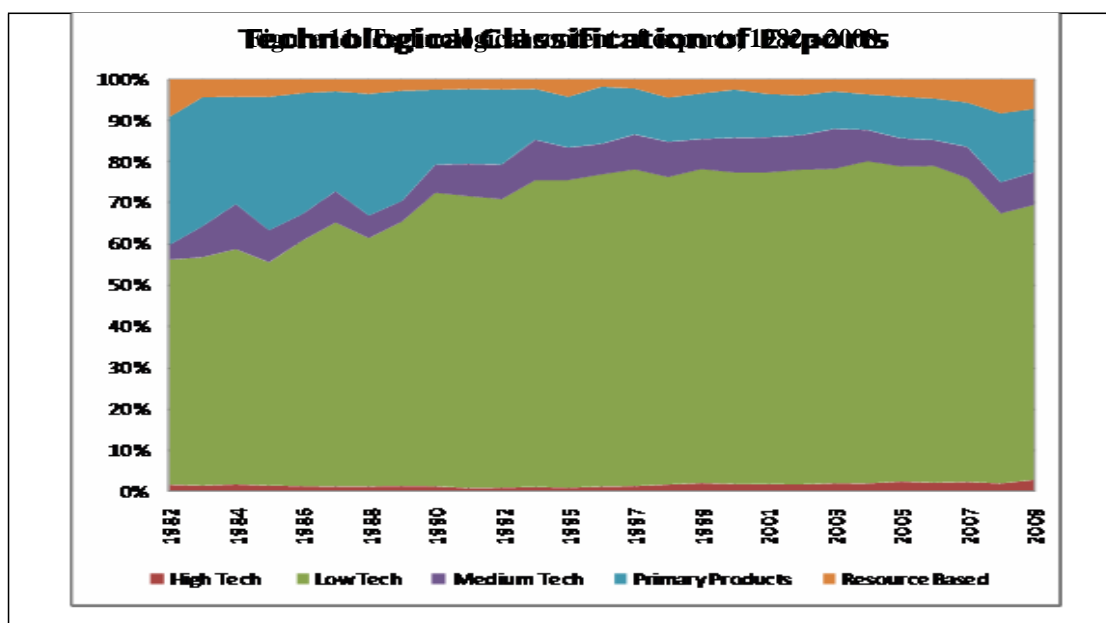
Table 4. FDI Inflows, 2005-2009
(as percent of Gross Fixed Capital Formation)

Bangladesh	6.0	5.3	4.0	5.7	3.3
China	7.7	6.4	6.0	5.3	4.0
Egypt	32.3	47.8	42.2	31.2	22.3
India	3.0	6.8	6.3	9.6	8.4
Indonesia	12.3	5.6	6.4	6.6	2.9
Iran	5.7	2.7	2.2	1.8	4.0
Pakistan	11.5	16.4	18.7	18.3	8.2
Thailand	15.8	16.4	17.4	11.4	9.2
Turkey	9.9	17.1	15.9	12.5	7.3
Viet Nam	11.6	11.8	24.8	25.5	12.8

Source: UNCTAD

9. Technological Content

98. The technological sophistication of exports is low for a country which has good educational and research institutions, and a large population (Figure 11). Yet, despite a rising number of graduates in the secondary levels of the technology field, Pakistan has not yet converted raw talent to exports as high tech exports constituted less than 2 percent of the basket in 2008; a share broadly unchanged in the past 25 years. More importantly, while just over half of Pakistan's exports were classified as low-tech in 1985⁵³ the share of this category increased to 65.4 percent in 2008.



⁵² According to the World Bank Group's latest report on FDI regulations, Investing Across Borders 2010, 27 out of a total of 33 sectors are fully open to foreign capital participation. In the financial services sector, the Banking Companies Ordinance allows a maximum of 49 percent foreign ownership of Pakistani banks, while foreign capital participation in local insurance companies is allowed up to a 51 percent share.

⁵³ Lall, S. (2000). "The technological structure and performance of developing country manufactured exports, 1985-98", Oxford Development Studies, 28(3), pp. 337-369.

99. To contrast Pakistan with other success cases, demonstrates how potential may or may be converted into performance outcomes. For example, Vietnam's exports went from 0.7 percent to 3.8 percent of total in the same period while India's increased from 2.8 percent to 6.2 percent.

10. Product Quality

100. The opportunities to compete of quality are not the same for all products. Commodities and homogeneous manufactures offer less scope for quality upgrading as newer, differentiated products trade with quality competition and higher unit values. When supply is competitive, higher prices are generally associated with higher quality and therefore greater product differentiation. Increased exports quality is often measured at highly disaggregated levels to show firms augmenting export value per unit, such as that shown in Table 5.

Table 5. Unit Values for Products, 2000- 2010

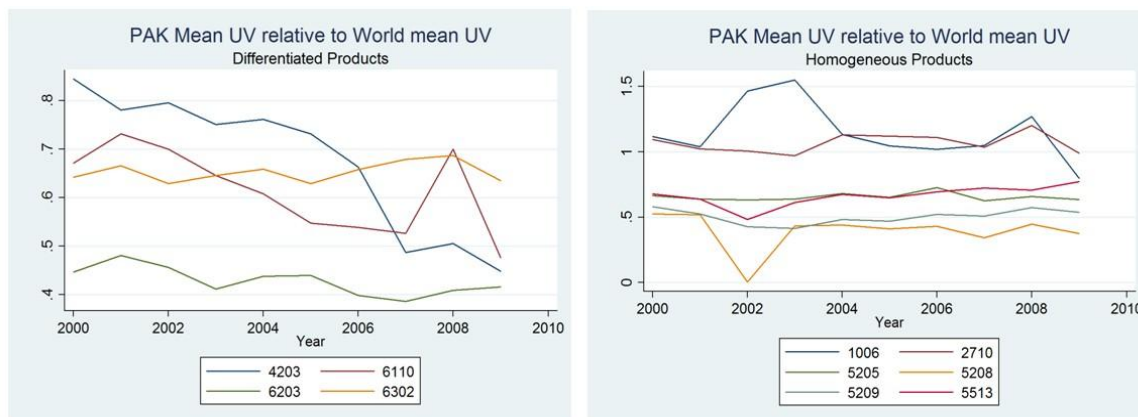
6302	Bed linen, table linen, toilet linen and kitchen linen.
5205	Cotton yarn (other than sewing thread), containing 85% or more by weight of cotton, not put up for retail sale.
1006	Rice.
6203	Men's or boys' suits, ensembles, jackets, blazers, trousers, bib and brace overalls, breeches and shorts (other than swimwear).
5209	Woven fabrics of cotton, containing 85% or more by weight of cotton, weighing more than 200g/m2.
5208	Woven fabrics of cotton, containing 85% or more by weight of cotton, weighing not more than 200g/m2.
4203	Articles of apparel and clothing accessories, of leather or of composition leather.
5513	Woven fabrics of synthetic staple fibers, containing less than 85% by weight of such fibers, mixed mainly or solely with cotton
2710	Petroleum oils and oils obtained from bituminous minerals, other than crude; preparations not elsewhere specified or included h
6110	Jerseys, pullovers, cardigans, waist-coats and similar articles, knitted or crocheted.

Product	Unit	2000			2007			2009			CAGR (%)	
		% of Exp	Mean UV (USD)	SD	% of Exp	Mean UV (USD)	SD	% of Exp	Mean UV (USD)	SD	00-07	07-09
6302	kg	10.5	6.5	10.7	14.3	11.5	70.2	15.4	6.8	11.9	8.6	-23.3
5205	kg	14.0	2.6	0.8	10.0	2.8	0.9	9.5	2.9	0.8	1.0	1.2
1006	kg	3.4	0.6	0.9	5.8	0.6	0.6	5.2	1.0	1.4	0.0	25.5
6203	item	3.4	8.0	5.8	4.4	42.1	295.9	5.1	19.8	69.8	26.9	-31.5
5209	kg	4.4	3.9	1.8	3.7	5.1	3.9	3.5	6.9	9.6	3.9	16.5
5208	kg	4.1	4.1	2.1	3.7	5.3	3.5	3.6	4.9	2.5	3.6	-3.6
4203	kg	5.3	19.9	11.9	3.0	30.0	75.8	3.6	29.0	30.6	6.0	-1.7
5513	kg	3.9	4.1	2.1	2.9	4.4	2.3	2.0	4.8	3.9	1.1	4.8
2710	kg	0.5	0.3	0.1	2.8	3.2	5.2	1.9	30.4	82.1	38.3	209.9
6110	item	4.5	6.9	3.9	2.7	9.9	6.4	2.5	15.8	52.1	5.3	26.0
Total exp		54.0			53.3			52.1				

101. Pakistan's exports mix a set of differentiated goods, such as linens, men's suits, leather knitted or crocheted jerseys with a predominance in commodities, such as rice, cotton yarn which had largely a low price and low volatility in world markets, until recently. Over the last decade, Pakistan has upgraded overall export quality of differentiated products as shown by the increase in the mean unit value and standard deviations between 2000 and 2007, albeit, at a slower pace than average quality upgrading by world exporters (Table 5 and Figure 12). While relative prices for Pakistan exports has remained stable for homogeneous products, relative unit value for important

differentiated products has decreased, such as in linens (4203) (the most important product in terms of export value) and knitted or crocheted jerseys (6110), signaling challenges in quality competition post MFA, (2004).

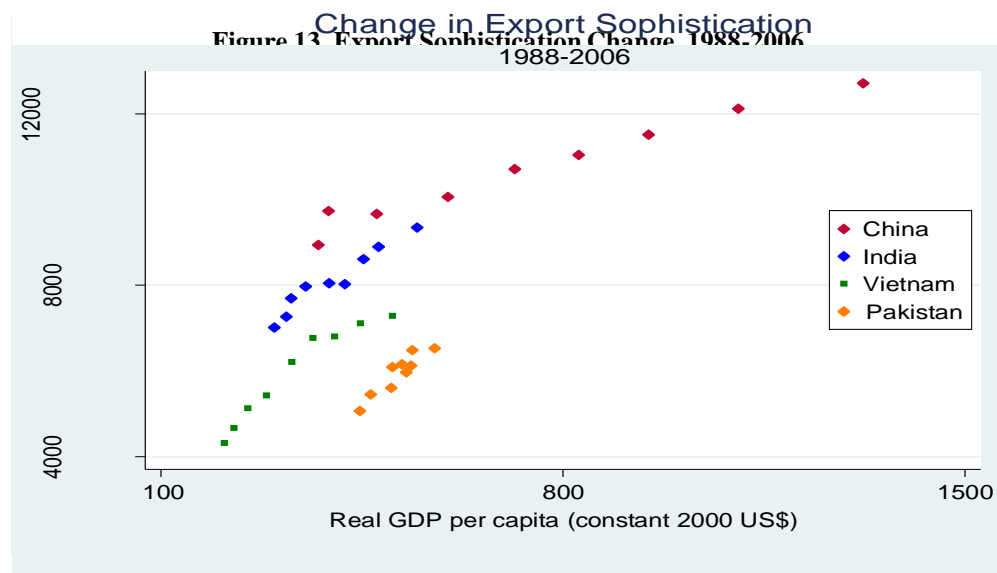
Figure 12. Relative Unit Values for Pakistan Exports, 2000-2010



Source: Text.

11. *Sophistication of Exports*

102. Other measures confirm the modest increase in Pakistan's export sophistication. Export sophistication (EXPY) over time gives an important indication of the relative growth in sophistication of the export basket.⁵⁴ In the past two decades Pakistan export sophistication has not grown in accordance with its Asian peers. Already, by 1986, Vietnam had caught up and surpassed Pakistan's export sophistication (Figure 13).



⁵⁴ Hausmann and Klinger (2007) have shown for a large pool of countries that export sophistication at present is a good predictor of economic growth in the future. Felipe (2010) estimates that a 10 percent increase in EXPY at the beginning of period raises growth by about half a percentage point.

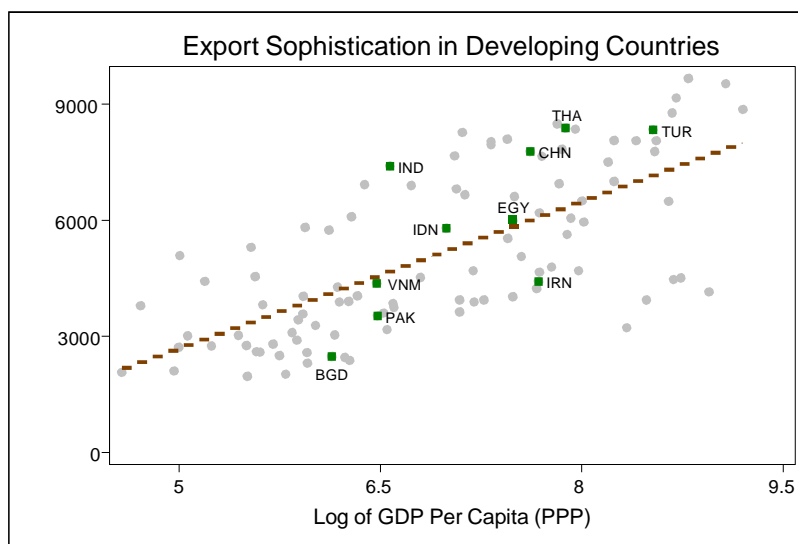
Box 1. Sophistication of exports in Pakistan

Hausmann, Hwang and Rodrik (2006) show that the level of “sophistication” of products matters for economic growth. Countries that have a more sophisticated export basket, proxied by a measure named EXPY, enjoy accelerated subsequent growth while those with less sophisticated export baskets tend to lag behind—in essence, countries become what they export. In a sample of 100 developing countries that the World Bank has classified as either low or middle income, Pakistan lies below the regression line implying that its export basket is “poorer” than it is. This is based on one of the measures of export sophistication (EXPY) which assesses the export baskets of countries by the incomes of countries that produce similar products, weighted by the share of those exports in the national total. Developing new products is much more important for countries below the line. In contrast, countries above the line can expect to see growth from existing products. This includes not only China and India, but also Thailand and Turkey that stand out for producing goods that are deemed sophisticated and therefore notable for countries at comparable levels of economic development.

past two decades Pakistan export basket

improvement as its Asian peers. China has made the biggest leaps in upgrading the income-content of its export baskets, although starting already from high basis. The assembly role of China

performance of this country. The kind of leap that China has demonstrated is only possible as the productive base increasingly mimics rich countries by producing what they produce. With data able to account for fragmentation of production, the picture would be more nuanced.

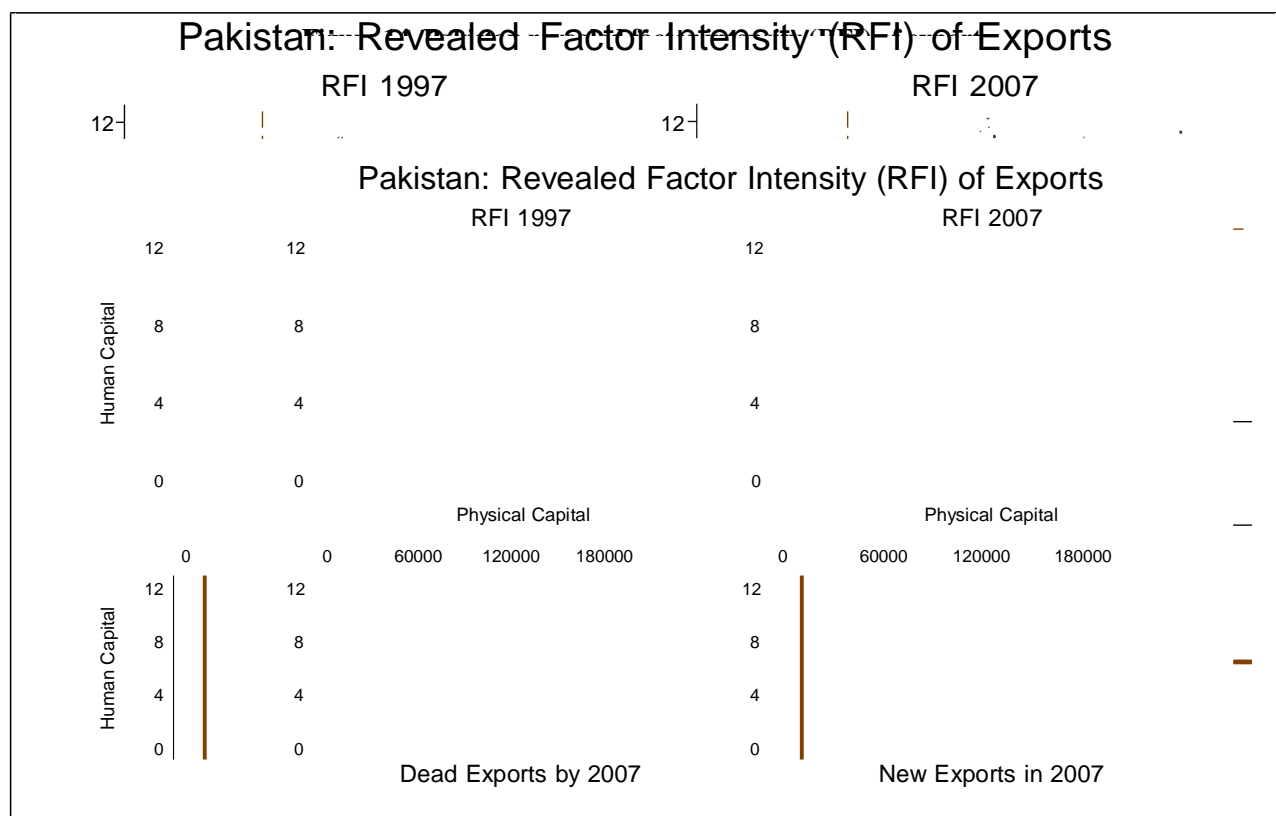


12. Revealed Factor Intensity of Exports

103. At the highly disaggregated HS 6-digit level, the factor content of Pakistan’s exports⁵⁵ is consistent in its domination by low human and physical capital content. In 1997 and 2007 Pakistan’s biggest export earners utilized capital - on either dimension - below the median exports,⁵⁶ but between 1997 and 2007, Pakistan’s human capital increased while physical capital (per worker) fell. The picture in 2007 was more positive as the median values of capital content increased and some major export earners using more than the median capital. There were also a greater number of exports earning more than US\$10,000 (each bubble in Figure 14). Several big export earners that existed in 1997 but not in 2007 embodied much more capital than the national average while the majority of “new” exports—active in 2007 and not 1967, were moderately capital-intensive.

⁵⁵ Database available at <http://r0.unctad.org/ditc/tab/index.shtm>. The indices are computed by weighting the factor endowments of all countries exporting a particular product; weights are derived from a modified version of the Revealed Comparative Advantage (RCA). Goods that are predominantly exported by countries rich in human capital are revealed to be intensive in human capital. See Cadot et al. (2009).

⁵⁶ The first two graphs on the top panel below plot products with human capital content on the x-axis and physical capital content on the y-axis, with bubble size representing the US dollar amount of exports in. The dashed reference lines are median values of revealed human and physical capital for exports (above US\$10,000). The quadrants are formed by lines corresponding to the *medians* of capital intensity and log of export values for Pakistan.



104. Though exports depend on an array of factors,⁵⁷ fundamentally, exports out of line with comparative advantage have a theoretically higher rate of failure. Several areas to investigate are: (i) whether the exports that die represent attempts to produce goods that require a different mix of factor endowments, and (ii) how close to the average endowment point are factor intensities of exports.

13. *Product Space Analysis*

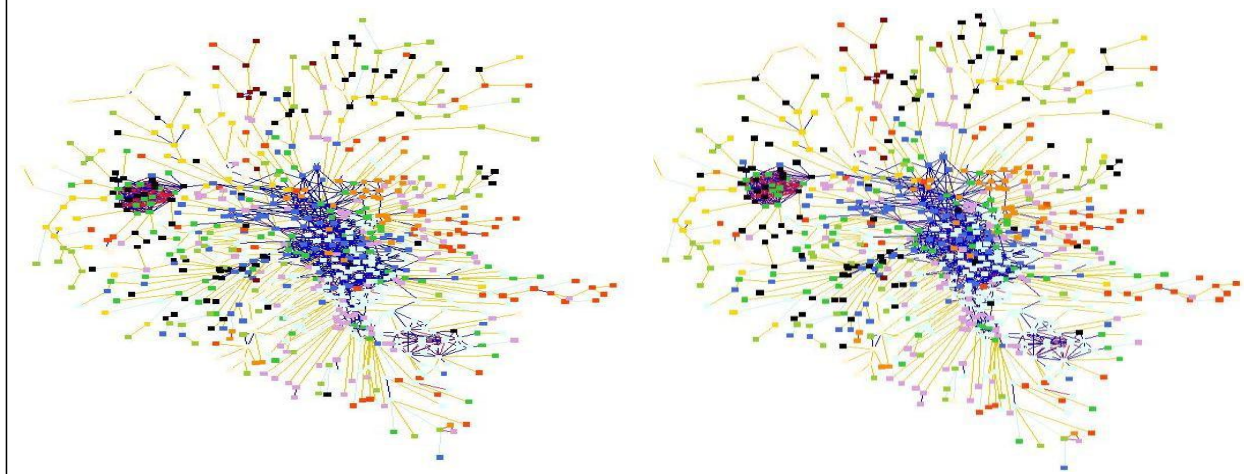
105. The product-space analysis indicates what merchandise goods Pakistan exports competitively, and whether the portfolio has undergone a structural transformation over the past decades (Figure 15).⁵⁸ The product space maps indicate all tradable products at the SITC 4-digit level, with the black dots representing exports in which Pakistan has a RCA.⁵⁹ The “garment cluster” on top, is where Pakistan has had products in both years with RCA greater than 1. Pakistan has also performed well in textiles—a capital intensive generally produced by more advanced countries. Between 1993 and 2008, Pakistan increased the number of agricultural and labor-intensive products in which it had comparative advantage, but not in sophisticated products.

⁵⁷ For example, Easterly et al. (2009) cites a role for fortuity in a random product being a “hit” in a certain destination leading to substantial growth, imitation and concentration of a few successful export items at a given time.

⁵⁸ Firms can build up competence in producing a certain good and redeploy human, physical and institutional capital more easily for goods that are “nearby.” However, structural transformations are not smooth movements along a continuum but a messy process beset by market failures. Hidalgo et al. (2007). Products are grouped to form dense and sparse parts of the map. RCAs in denser parts suppose “country-level” opportunities for product upgrading.

⁵⁹ The center of the product-space, for example, is quite dense with better connectedness among industries related to metallurgy, vehicles, machinery, etc. To the bottom right of the product-space lie the more sophisticated electronics and chemical industries. The scattered industries on the upper half are largely agricultural and resource-based.

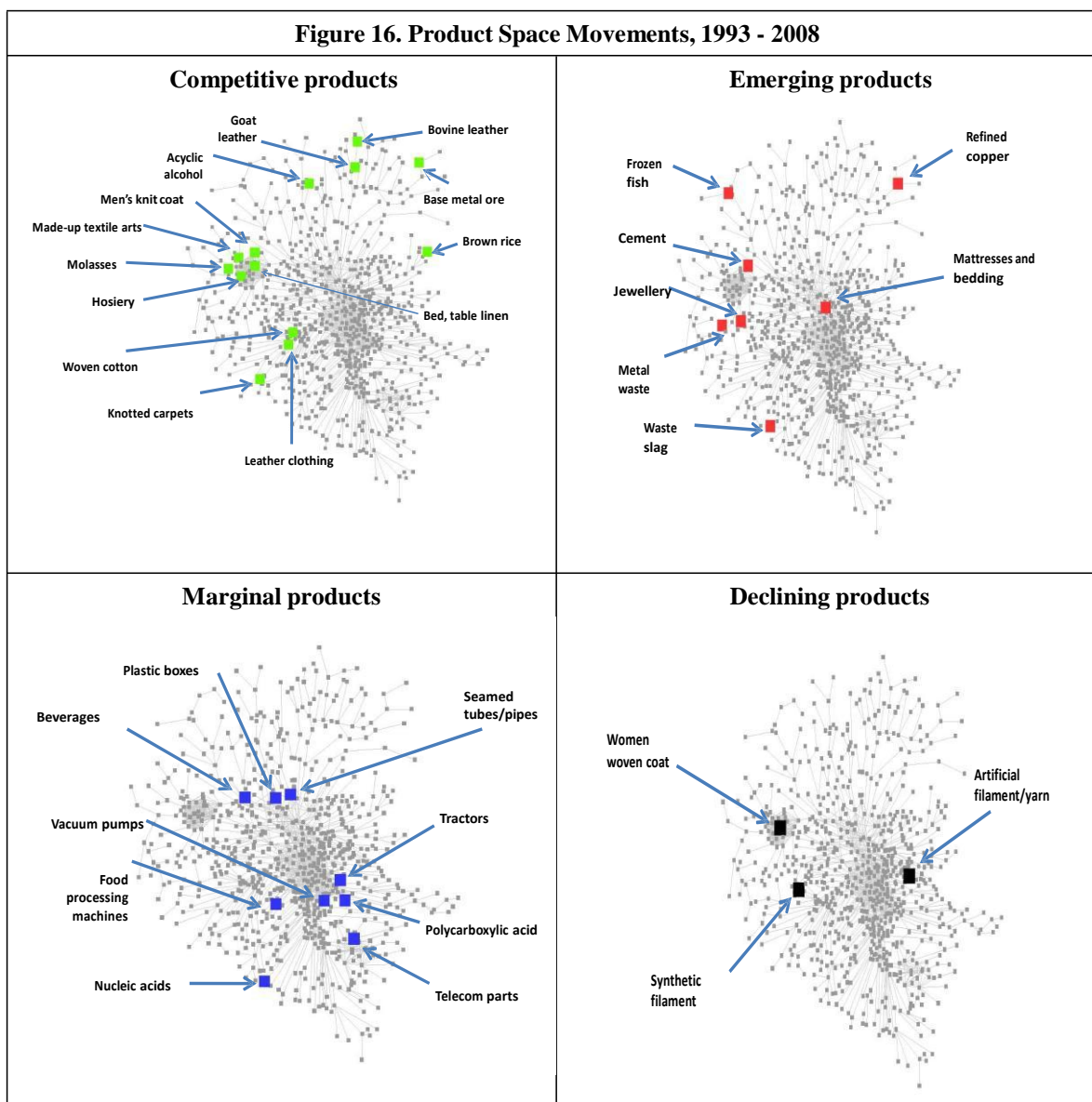
Figure 15. Product Space, 1993 and 2008



106. Overall, on the sophistication front, Pakistan presents a picture of inadequate upgrading into higher-value exports over time. The textile industry is dominant, and given that it is more capital intensive than apparel, Pakistan is better placed to move laterally into more sophisticated manufacturing activities requiring a similar mix of skills and endowment, e.g. from cotton-based textiles to man-made fibers and fabric. Using this analysis allows the main set of exported products to be placed in one of four categories for further analysis at the industry, firm or product level:

- **Consistently Competitive Products:** 103 products with an RCA greater than 1 in both 1993 and 2008, textiles and garment items such as linen, cotton, curtains, carpets, men's coats, and leather clothing. Figure 16 shows top products from this category (at least 0.5 percent share in Pakistan's 2008 exports). On the product space map, the textile cluster comes closest to the denser, high-value manufacturing industries. There is no Pakistani export (with $RCA > 1$) firmly embedded in this part of the product space.
- **Growing Competitive Products:** 38 products did not have an RCA greater than 1 in 1993, but did in 2008. These "emerging" products with at least 0.2 percent share of national exports in 2008⁶⁰ include high value exports like beddings and mattresses, frozen fish, jewelry, cement and metal waste with shipping-dependent heavier products likely to be more competitive in regional markets.
- **Marginal Products:** 400 products had an RCA of less than 1993 and 2008. Those, with a share in national exports of at least 0.05 percent, include vacuum pumps, chemicals (acids), wheeled tractors, telecom parts, food processing machines.
- **Falling Products:** 20 major products were competitive in 1993 but were not in 2008, of which three of them which had an export share of at least 0.05 percent in 1993, including some textile and garment products no longer able to withstand external competition.

⁶⁰ Note that the product space maps consist of 775 products, whereas medium to large sized countries typically produce more than this number. Several products that Pakistan exports cannot be mapped on the product space.



C. Firm Dynamics In Exporting: Entry, Exit and Survival

1. Introduction

107. Focusing on the dynamics of firm behavior in exporting between 2002-2010, this section examines how export values are distributed across destination countries, sectors and products, and describes the entry, exit and survival of exporting firms in these markets over time.⁶¹ Two aspects of churning are examined: the extensive margin refers to the entry and exit of new firms, new products

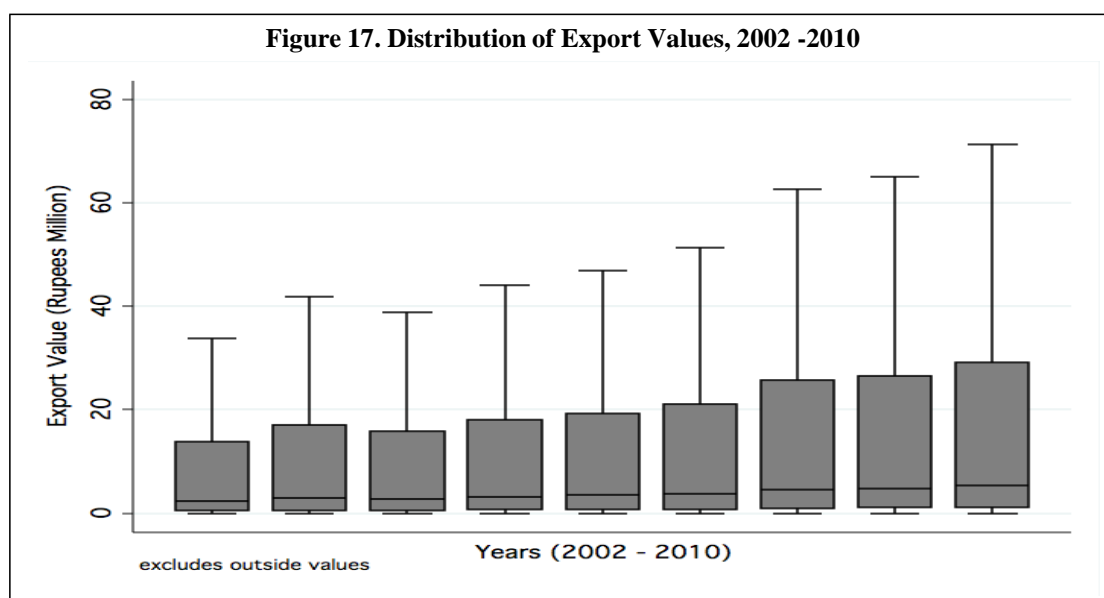
⁶¹ A sector refers to HS 2-digit industry classification, while by product refers to the HS 8-digit. The term country will be used interchangeably with destination.

and new markets, and the intensive margin referring to the survival of firms and products and deepening in existing markets.⁶²

108. The focus will be on identifying the type of churning creating the dynamic in exporting described in the earlier section. Dynamic firm relations encompass two aspects of those relations: newly established and those which continue to survive and continue to grow. Both types will be examined in terms of (i) the extensive margin: entry of firms into the exporting of new products and/or to new destination countries, and (ii) the intensive margin: survival and persistence of these relationships.

2. *Distribution of Exports*

109. Exports from Pakistan are skewed towards large exporters (Figure 17)⁶³ and the skewness of the data seems to increase over time, indicating that exports becoming more concentrated towards fewer larger firms.

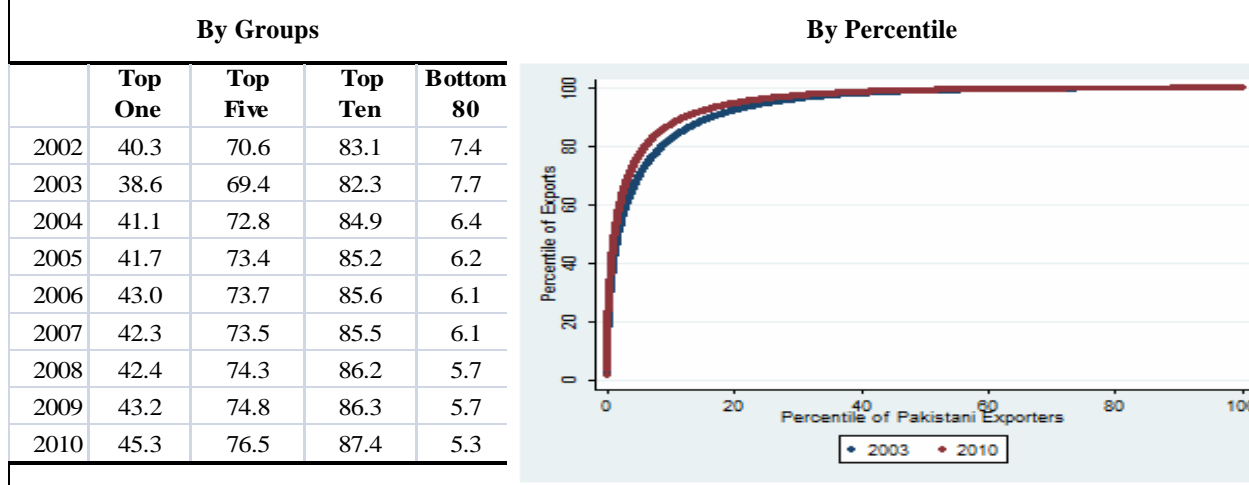


110. The contribution of export values by the top exporters shows how values are skewed towards the largest exporters that account for anything between 38 to 45 percentage points of the total export value in a given year. On the other hand, the bottom four fifths of exporters account for only 5 - 7.5 percent of total export value. Large differences between the top percentiles and the bottom percentiles exist no matter what way the data is spliced. The concentration however has not changed much over time between 2002 and 2010 (Table 6).

⁶² There is debate about the relative impact of each margin with some concluding that the extensive margin is the primary avenue for export growth (Hummels and Klenow 2005), while others have found the dominant role to be played by the intensive margin (Helpman, Melitz and Rubinstein 2008).

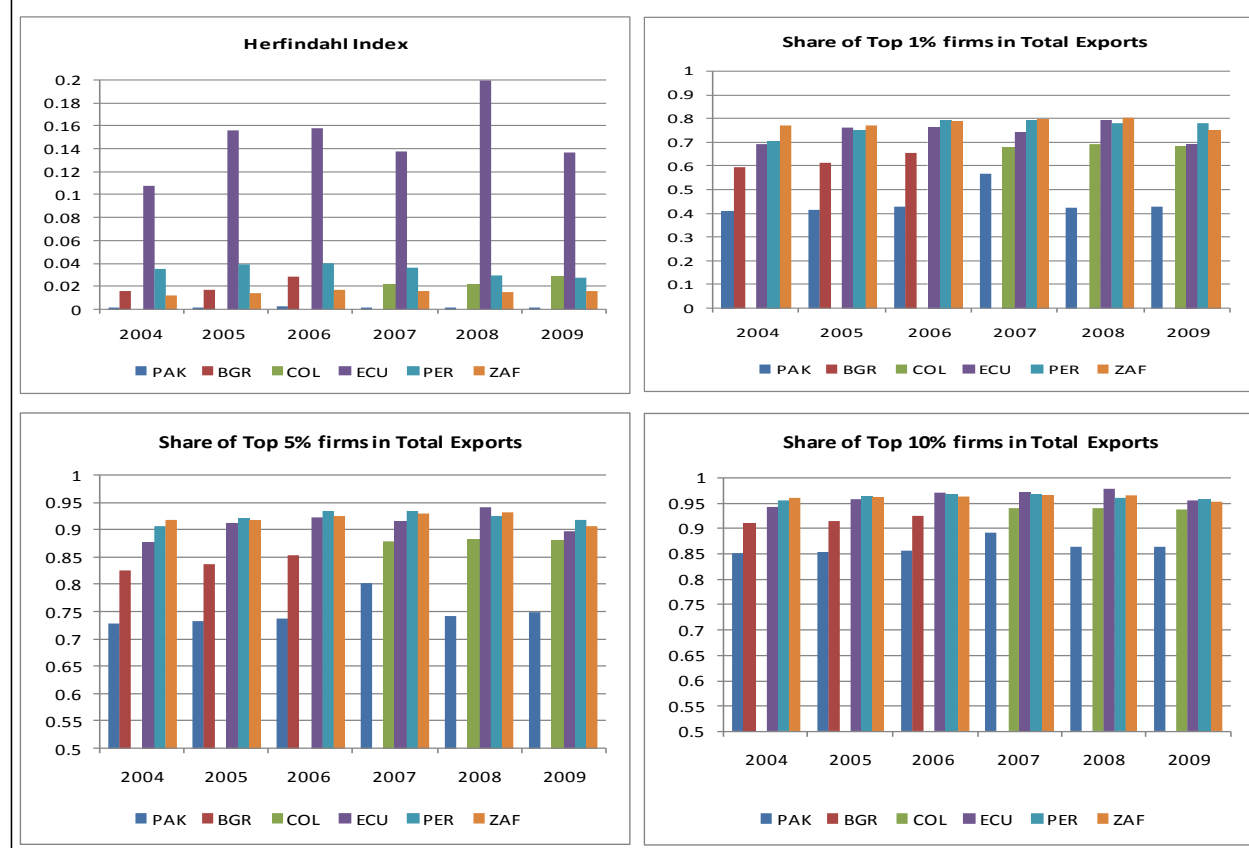
⁶³ Normally distributed exports would have the line (median) in the middle of the box specifying the 25th and 75th percentiles with whiskers (5th and 95th percentile) equidistant from the box. The plot depicts that export values are positively skewed with the median pulled to the lower end and the 95th percentile stretched away.

Table 6. Distribution of Exports Across Firms, 2002-2010



111. Concentration in Pakistan is lower than in many other industrialized and developing countries. In Belgium, France, Germany and Norway, the top 10 percent of exporters account for a share of exports of 90 percent or more while Great Britain and Italy are less concentrated than Pakistan. However, as compared to more similar peer groups, including Bulgaria, Colombia, Ecuador, Peru and South Africa, Pakistan is also less concentrated (Figure 18).

Figure 18. Herfindahl index and Top Exporters Share, 2004-2009



112. The lower concentration of exports in Pakistan is due to the presence of a large number of small exporters. While the average size of exporters in Pakistan is lower than in countries such as Bulgaria, Colombia, Ecuador, Peru and South Africa, the median is higher, suggesting that in Pakistan large exporters determining the bulk of exports, but small exports are plentiful.

Figure 19. Average and Median Export Value per Firm, 2004-2009

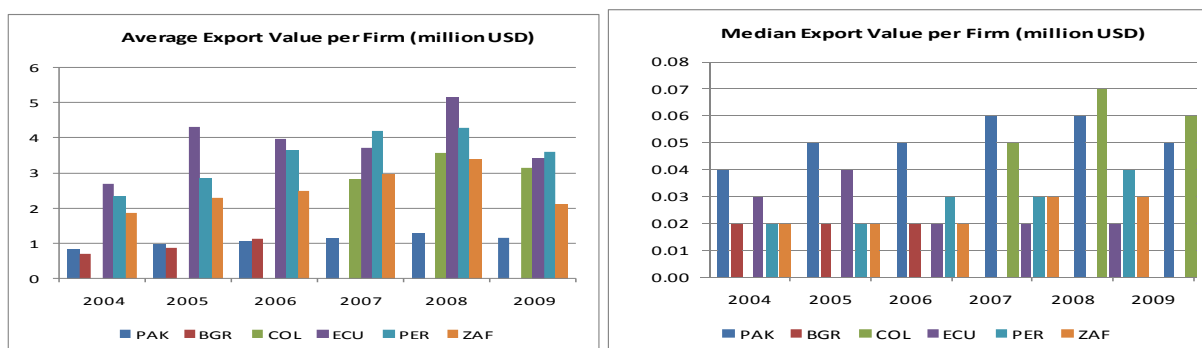
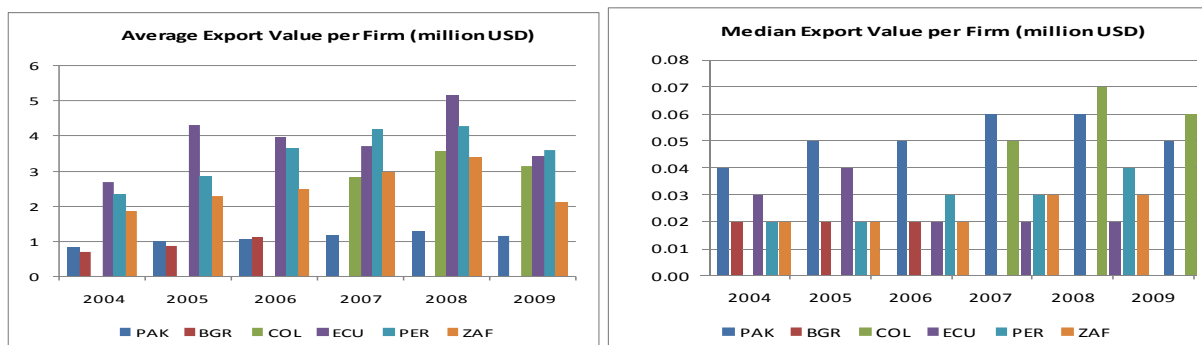


Figure 19. Average and Median Export Value per Firm, 2004-2009



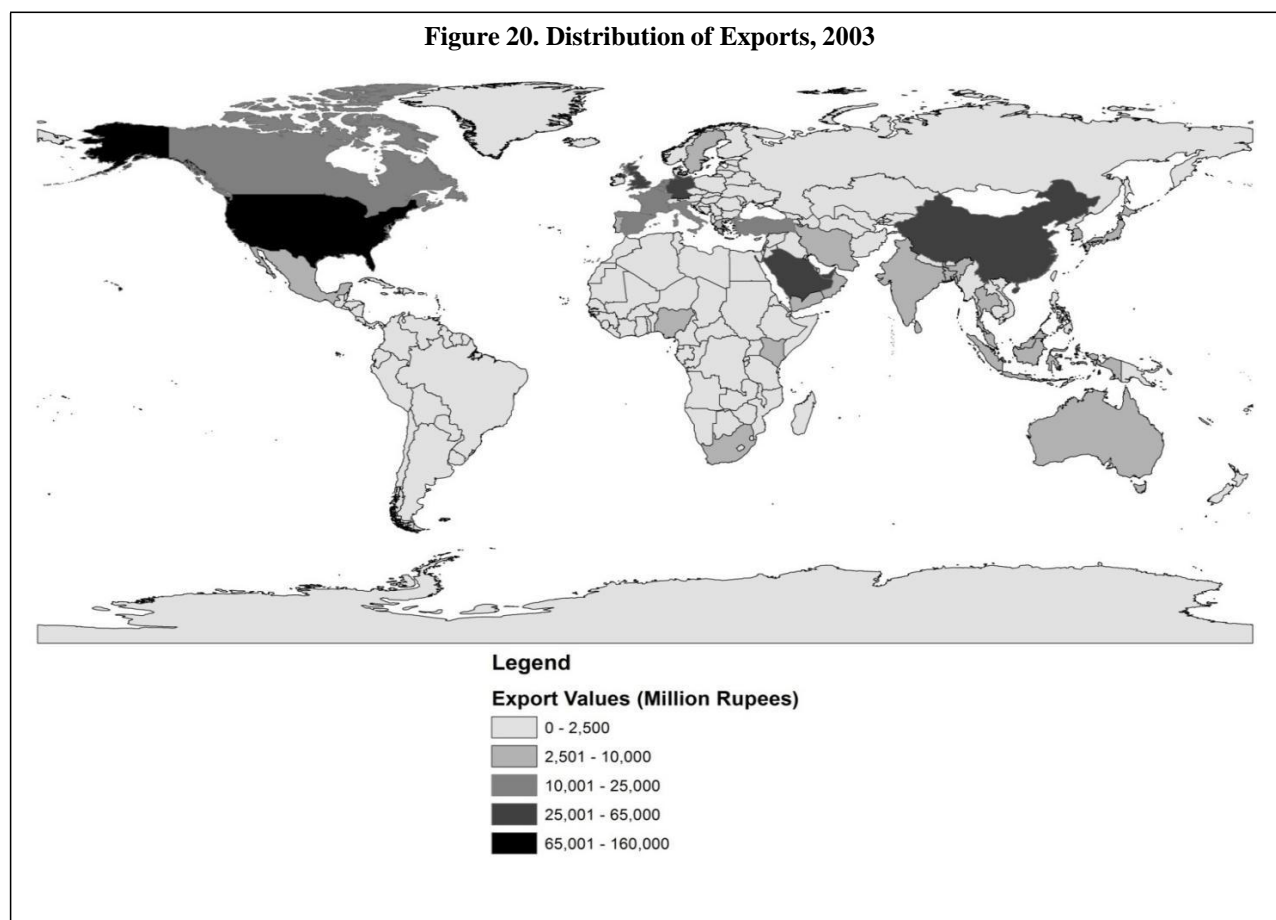
113. As in most countries, Pakistan's top exporters account for a large proportion of export values and export more products to more destination countries. The total number of firms, destinations, sectors and products in the database are summarized by each year in the first few rows and broken down by averages by groups. The top 1 percent of firms export between 21 and 50 products to 20 destinations, while the lowest 80 percent of firms export two to four products to 1 to 2 destinations (Table 7).

Table 7. Destinations, Sector and Products, 2002 - 2010

Total Number									
Firms	14,747	14,701	14,730	14,565	14,696	15,076	15,358	15,676	15,925
Destinations	203	212	220	219	216	209	208	202	205
Sectors	98	98	97	97	97	99	98	98	98
Products	2,470	3,043	4,068	4,361	3,843	4,726	4,329	4,523	4,422
Average for all Exporters									
Destinations	2.9	3.0	3.1	3.2	3.3	3.3	3.2	3.2	3.3
Sectors	2.5	2.6	3.2	3.1	2.9	3.0	2.7	2.7	2.6
Products	3.8	4.3	5.8	6.3	5.6	6.5	5.8	5.6	5.5
Average for Top 1% Exporters									

Destinations	19.6	19.3	20.7	20.2	21.3	21.6	18.9	20.2	20.8
Sectors	7.8	7.4	10.0	9.3	6.5	5.4	4.9	5.1	4.8
Products	26.6	27.5	47.3	49.5	33.2	29.2	22.8	23.1	21.2
Average for Top 5% Exporters									
Destinations	11.9	12.7	13.1	13.4	13.4	13.2	12.8	13.0	12.8
Sectors	6	5.7	7.9	7.0	5.1	4.6	4.3	4.7	4.6
Products	16.4	16.7	27.6	28.5	19.6	18.6	15.4	16.7	15.8
Average for Top 10% Exporters									
Destinations	9.4	9.7	10.3	10.6	10.7	10.6	10.2	10.1	10.2
Sectors	5.4	5.2	7.0	6.2	4.7	4.4	4.0	4.2	4.2
Products	12.8	13.3	21.0	21.6	15.8	16.0	13.5	14.0	13.6
Average for Bottom 80% Exporters									
Destinations	1.9	2.0	2.0	2.1	2.1	2.1	2.1	2.2	2.2
Sectors	2.0	2.2	2.6	2.6	2.5	2.8	2.4	2.4	2.4
Products	2.4	2.9	3.5	3.9	4.0	4.9	4.4	4.1	4.1

114. As summarizing by the map in Figure 20, the distribution of exports across destinations in 2003 found five countries - China, Germany, UAE, the UK, and the US - accounting for half of total export values and 20 countries accounting for over 80 percent. Moreover, export values are skewed toward the range products being exported to various countries, meaning the destination is product specific.

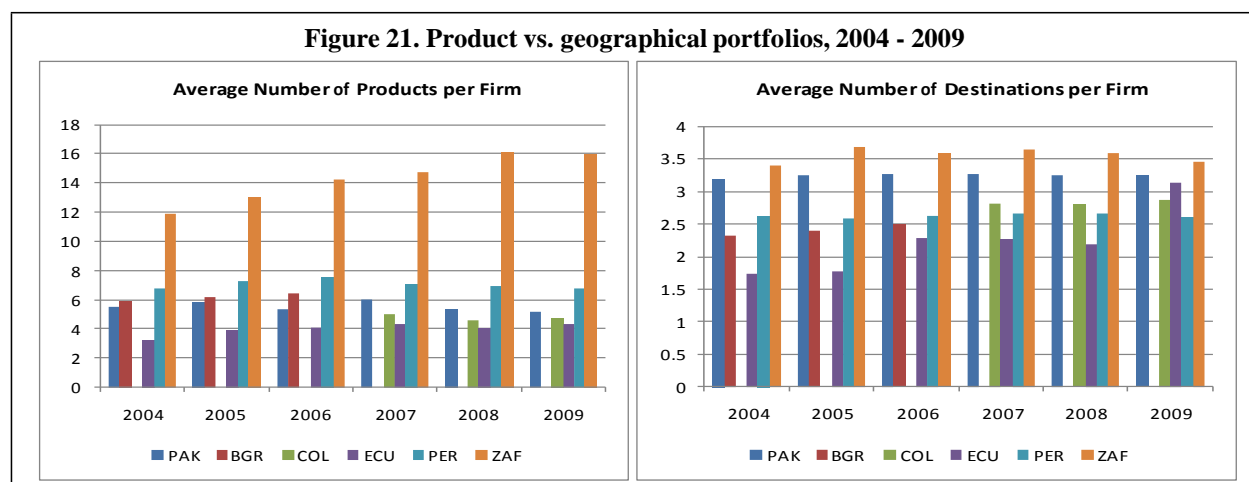


115. When cross tabulating the number of products and number of countries in 2002—by number and by value, further evidence of a few dominant firms is apparent. One third of firms sell one product to one country while 2 percent of firms sell more than 11 products to more than 11 countries. However, by value, firms exporting one product to a single country account for around one percent of total exports while firms exporting more than 11 products to over 11 countries account for more than half (Table 8).

Table 8. Export behavior: Countries & Products, (2002)

1 Product	32.4	1.2	3.7	0.9	0.1	0.1	0.0	0.0	36.2	2.2
2 to 5	17.5	2.8	24.1	10.0	2.6	2.9	0.6	1.9	44.7	17.7
6 to 10	1.4	1.0	6.8	8.0	3.1	6.2	1.3	7.0	12.6	22.2
11 and above	0.2	0.4	1.9	7.0	2.1	9.5	2.4	41.1	6.5	58.0
Total	51.3	5.4	34.6	25.9	5.8	18.7	1.9	50.1	100.0	100.0

116. Compared to peer countries, Pakistan has a low average number of products per exporter but a high average number of destinations per exporter (Figure 21). Together, this means Pakistan posts a high concentration of exports in the hands of a limited number of large exporters.



117. When exploring the characteristics of high-performing “gazelle” exporters (firms with an episode of an annual growth rate of at least 75 percent for four consecutive years between 2001 and 2010), a few important observations emerge:

- Smaller firms on average concentrate growth in a few products but are well diversified in terms of destination markets.
- Larger top-performing firms diversify exports across more countries and across more products and away from South Asia.
- But, smaller firms, export mostly to other South Asian countries while larger exporters diversify away from other South Asian countries.

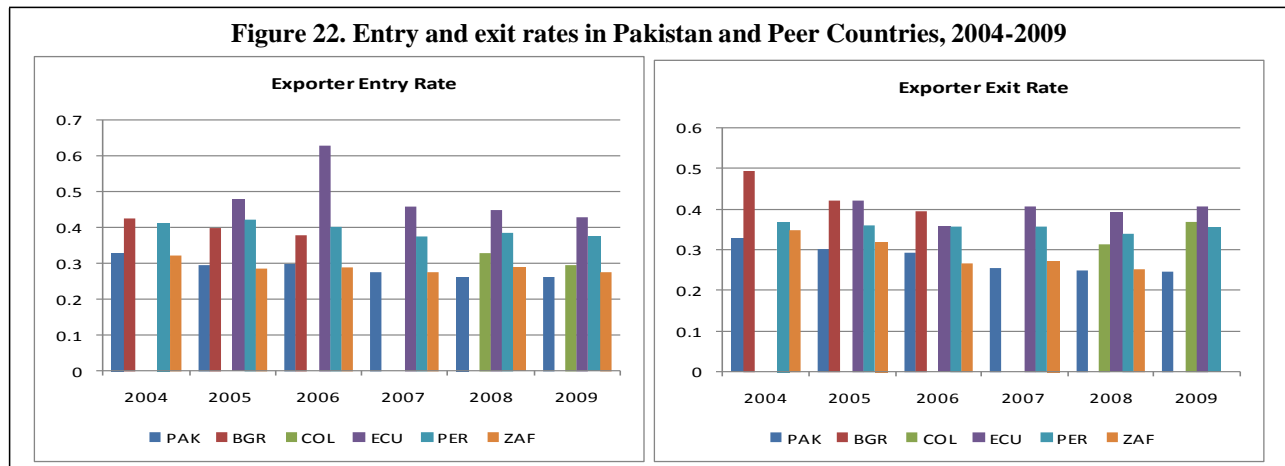
3. *Extensive Margin*

118. Survival rates provide an overview of how well exporters are able to continue and deepen their trade relations across new markets. Rates of entry and exit which reflect the dynamics of firm movements in and out of destinations and products, shows a significant churning of exporters—anywhere between 16 to 37 percent of firms exit while another 19 to 37 percent enter each year (Table 9).

Table 9. Export Entry and Exit, 2003-2010

2003	5,481	37.3	5,435	37.0	-46	-0.3
2004	4,368	29.7	4,397	29.9	29	0.2
2005	3,798	26.1	3,633	24.9	-165	-1.1
2006	3,497	23.8	3,628	24.7	131	0.9
2007	2,870	19.0	3,250	21.6	380	2.5
2008	2,775	18.1	3,057	19.9	282	1.8
2009	2,664	17.0	2,982	19.0	318	2.0
2010	2,597	16.3	2,846	17.9	249	1.6

119. While this seems to be significant, the rates are in fact lower than peer countries and the net effect is marginal (Figure 22).

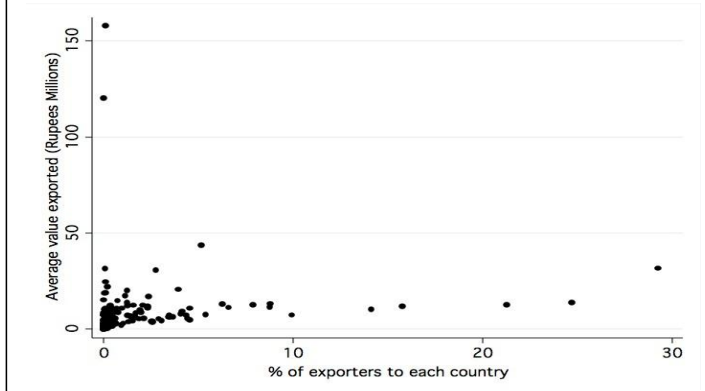


120. In examining products and sector that see the most churning in the data (i.e. the most popular new products exported by new firms), there is some concordance between sectors with the introduction of new products and a large increase in export value owing to the introduction of these products. Looking at the top ten HS2-digit sectors arranged in this way,

- Sectors with entry of new products and rising export values include, mechanical appliances, (84), electrical machinery and equipment, (85), organic chemicals (29), and live animals (01).
- Sectors with entry of new products and little export value include tanning and dyeing extracts (32), inorganic chemicals, (28), precision equipment (90), and iron and steel (72).

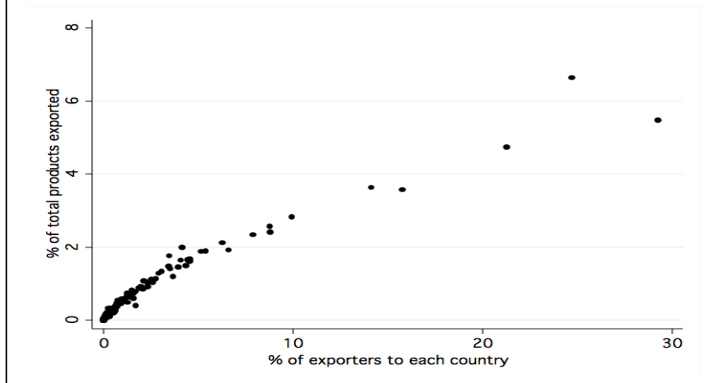
121. It is also clear that certain markets are more difficult to break into. In particular, when comparing the average value of exports with the percentage of exporters that export to a given country, most countries account for a small share of total exports, and that, on average firms on average export small values (Figure 23). In other words, there are only a few countries where firms with large export values are able to break into.

Figure 23. Destination popularity and Export Values, 2002



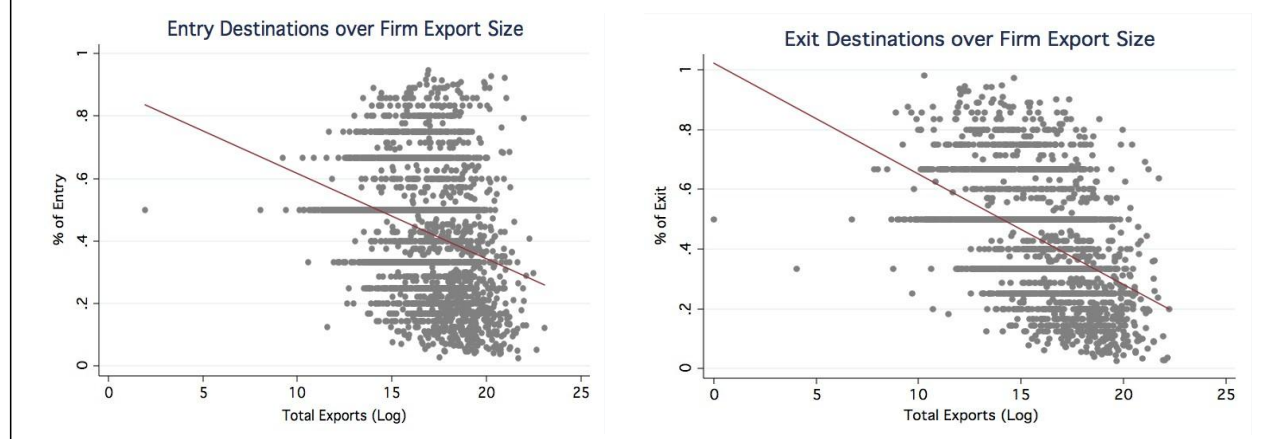
122. When comparing exports by country and products, there is a strong positive correlations between the percentage of exporters to each country and the total share of products exported, indicating that countries that are more popular destinations also account for a larger proportion of product shares (Figure 24). Thus there is evidence that some destinations are popular with smaller exporters, while others seem more difficult to reach, and that more popular destinations also account for more products and exporters. This suggests that country-specific entry costs may determine the export strategies of firm.

Figure 24. Products and Exporters, 2002

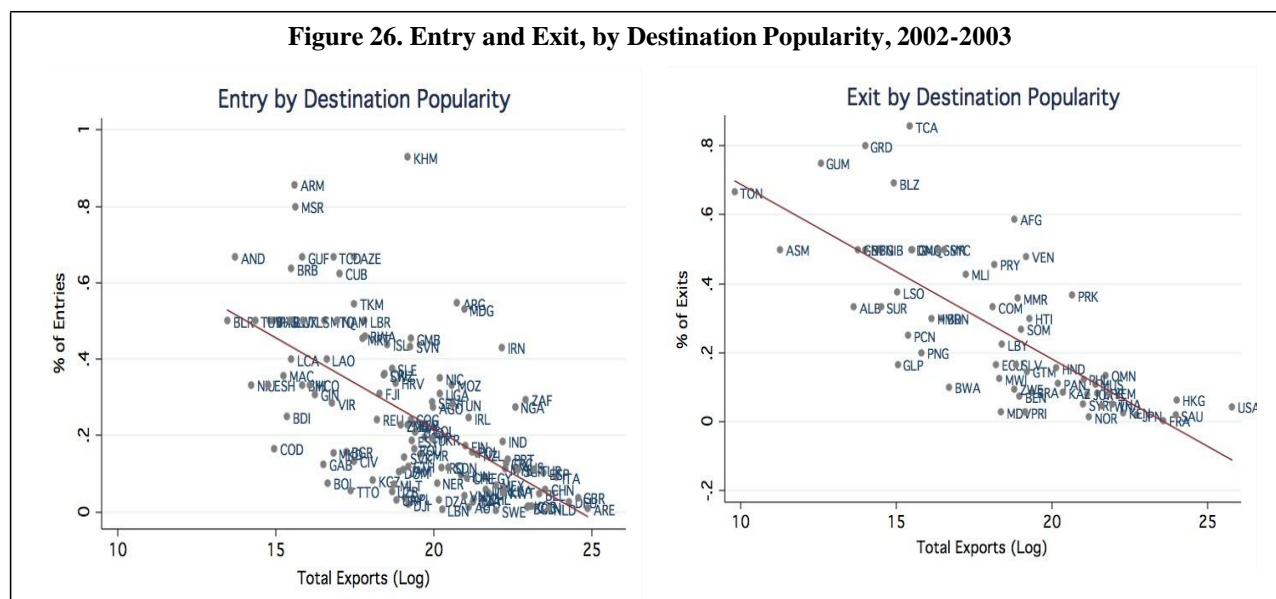


123. Understand the extensive margin requires examination of how churning in markets is associated with types of firms and destinations. When comparing the destinations entered and exited to the export value of each firm it is clear that churning is taking place at the lower end of the export value size distribution. Large firms have small number of export destinations entered and or exited (Figure 25).

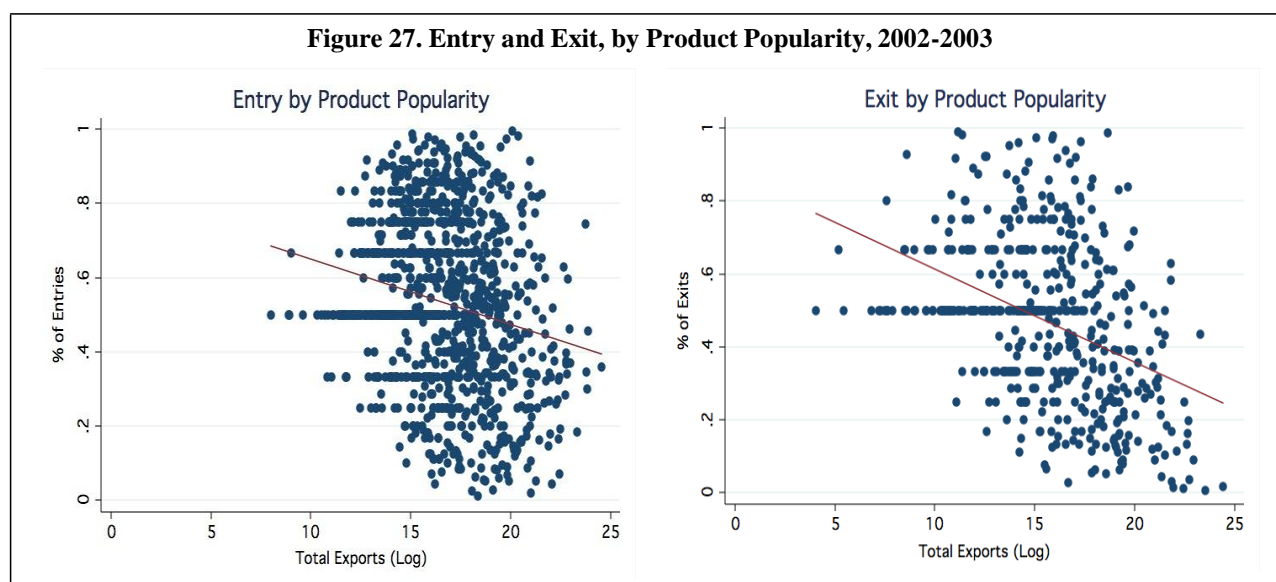
Figure 25. Entry and Exit, by Firm Size, 2002-2003



124. Focusing on the destination countries, it is equally clear that the fraction of entries and exits are lower in larger export markets. In other words, most of the churning of firms seems to be taking place in smaller destinations by export size (Figure 26).



125. Similar analysis across product categories yields a similar result. The fraction of entries and exits are lower for products with higher export values. Thus, consistent with the other dimensions of churning, entry and exit seems to be taking place predominantly in products with small average export size (Figure 27).



126. Entry and exit is more frequent for smaller firms, for smaller destination countries and for smaller products by export size. Two phenomena are driving these results:

- Larger exporters in terms of firm size, number of destinations reached, or number of products exported, are less likely to switch export strategies. Their success is determined by developments at the intensive margin.
- Second, export values become larger the more continuous the interaction, whether within particular destination countries or within product categories.

127. The conclusion therefore is that continuous interaction within the destination, suggests that determinants of the intensive margin, including a macro-economic environment conducive to stability and growth is important to ensure good export performance. In addition, deepening of exporting relationships through survival is also a determinant of sustained export performance.

4. *Intensive Margin*

128. As noted, even when looking at the extensive margin, ultimately success at the intensive margin is critical to the sustained export performance. Therefore, in describing exporter survival over time, association is made with particular [firm, country, etc] characteristics.

129. The survival rates show that of the 5,435 firms which started exporting in 2003, only 57 percent of the original 2003 cohort managed to continue the exporting in 2004 as 43 percent of firms exit from exporting in the first year. By 2010, after 7 years, only a quarter of the original cohort still exports⁶⁴ (Table 10).

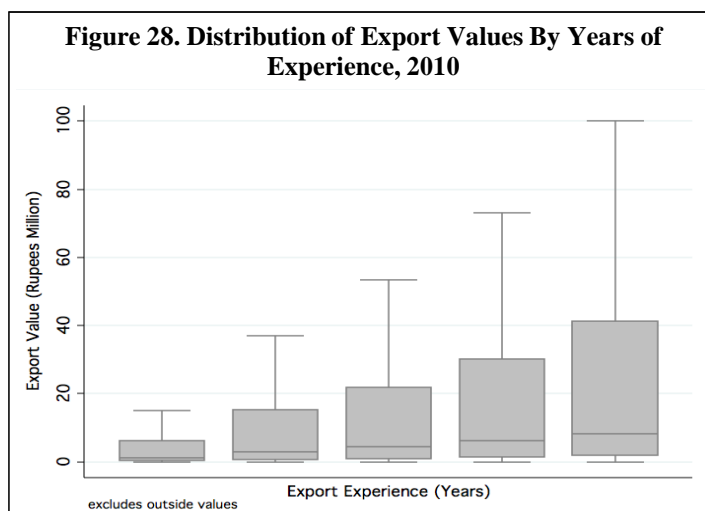
Table 10. Survival Rates by Cohort, 2003 -2010

2002										14,747
2003	63%	5,435								14,701
2004	49%	57%	4,397							14,730
2005	42%	44%	55%	3,633						14,565
2006	36%	36%	41%	54%	3,628					14,696
2007	33%	32%	36%	42%	66%	3,250				15,076
2008	30%	28%	32%	36%	53%	57%	3,057			15,358
2009	28%	26%	29%	32%	46%	45%	56%	2,982		15,676
2010	26%	24%	27%	29%	41%	40%	44%	58%	2,846	15,925

Notes: The top of each row provides the count of new exporters entering the market in the given year. The last column provides the sum total of exporters in each year.

⁶⁴ 2002 data refers to all active exporting firms as new entrants and incumbents are combined in the first year.

130. Furthermore, the value of exports varies significantly with continued participation in markets. While the average value of exports rises marginally with increasing years of experience, there is increasing divergence between the top and bottom quarter of exporters. The finding is suggestive of new entrants testing new markets with small shipments which increase with firm experience. It also suggests that not all firms can equally increase export values over time with some firms much more successful than others (Figure 28).



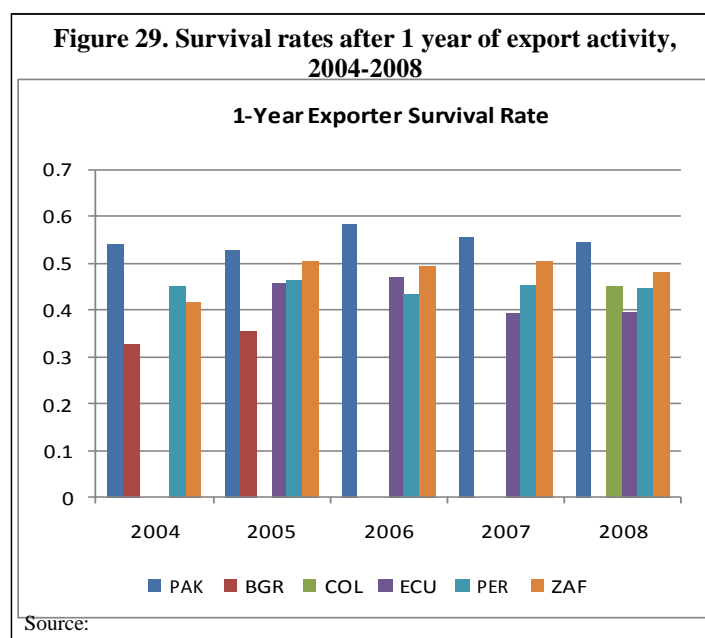
131. Although the survival rates of Pakistan's firm into exporting seem low, a comparison with those of exporters from other middle income countries for which these data are available shows that, after one year of export activity, the persistence of Pakistan's firms into exporting is higher than in other middle-income countries (Figure 29).

positive sign, taking account of other analyses showing a lack of exit by non-productive firms could signal a limited

relationships and robust export growth. At the extensive margin, a vibrant domestic economy generates domestic

growth firms and products.⁶⁵ Pakistan's performance in this respect is considerably deteriorating over time.

increased, the number of new exporters each year decreased, signaling less than optimum outcome in firm dynamics if export persistence is based on less entry and lower competition in the domestic market (Table 11).



⁶⁵ Melitz, 2003. Interestingly, less domestic competitive pressure also translates in a heightened persistence of export relationships (from further on).

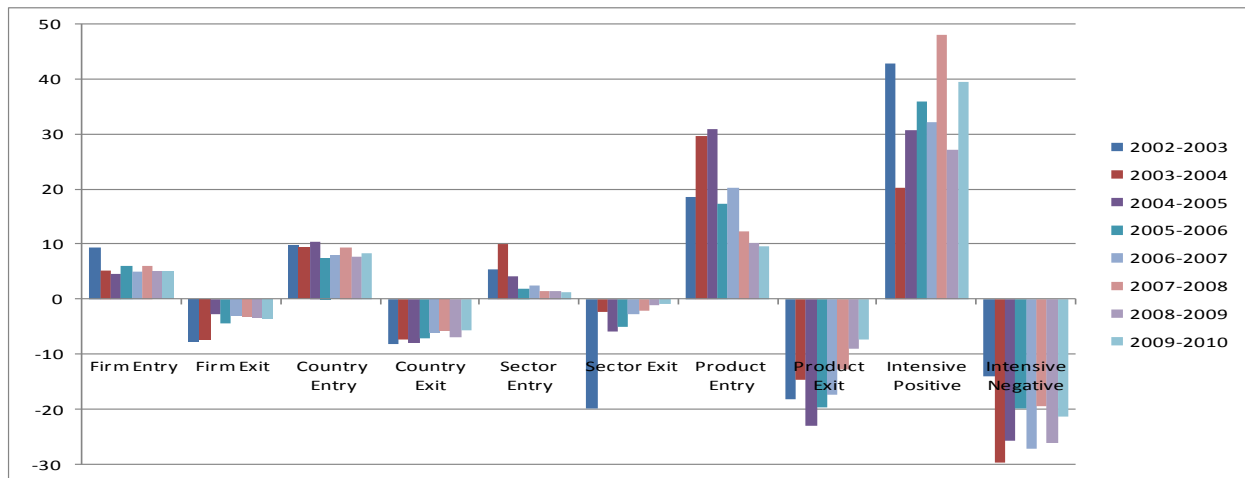
Table 11. The Margins of Export, Annual Export Growth, 2002-2010

Firm Entry	9.3	5.1	4.6	6.0	5.0	6.0	4.9	4.9
Firm Exit	-7.8	-7.3	-2.8	-4.4	-3.0	-3.2	-3.4	-3.5
Net Firm	1.5	-2.2	1.8	1.6	1.9	2.8	1.5	1.4
Country Entry	9.8	9.4	10.4	7.4	7.9	9.4	7.6	8.4
Country Exit	-8.1	-7.3	-7.9	-7.2	-6.1	-5.7	-7.0	-5.7
Net Country	1.7	2.1	2.5	0.2	1.8	3.7	0.6	2.6
Sector Entry	5.4	10.0	4.2	1.9	2.4	1.5	1.5	1.3
Sector Exit	-19.9	-2.4	-5.9	-5.0	-2.8	-2.1	-1.1	-0.9
Net Sector	-14.6	7.6	-1.7	-3.1	-0.5	-0.5	0.4	0.4
Product Entry	18.5	29.6	31.0	17.4	20.3	12.4	10.3	9.5
Product Exit	-18.3	-14.6	-23.0	-19.8	-17.4	-12.9	-9.1	-7.4
Net Product	0.2	15.0	8.0	-2.4	2.9	-0.5	1.2	2.0
Net Extensive	-11.2	22.5	10.5	-3.7	6.1	5.5	3.7	6.5
Intensive Positive	42.9	20.2	30.8	35.9	32.1	48.0	27.2	39.4
Intensive Negative	-14.0	-29.8	-25.8	-0.0	-27.2	-19.6	-26.1	-21.4
Net Intensive	28.8	-9.6	5.0	16.0	4.9	28.4	1.1	17.9
Total	17.6	12.9	15.4	12.3	11.0	33.9	4.8	24.4

5. Contribution of Destination, Sector and Product Margins to Export Growth

133. To investigate further whether the lower dynamism of firms exports has had a detrimental effect on export growth, the year-on-year contribution of the extensive and the intensive margin to aggregate export growth is decomposed,⁶⁶ in order to compute the contribution of the extensive and the intensive margin to export growth.⁶⁷ The decomposition provides the contribution to aggregate growth by each of the margins (Figure 30).

Figure 30. The Margins of Export, Annual Export Growth, 2002-2010



⁶⁶ Exports growth is computed using the mid-point growth rate Davis and Haltiwanger 1992 as applied to firm-level exports by Bricogne et al 2011.

⁶⁷ As compared to other methodologies which only allow a static assessment of the extensive margin Hummels and Klenow 2005.

Box 2. Contribution of Intensive and Extensive Margins to Export Growth

Reading Figure 30 - Decomposition of Export Growth for 2002-2003

- In each of the columns the average annual growth relative to the indicated period is reported. The aggregate figure for all trade flows is reported in the last row.
- The first row indicates that annual export growth in 2002-2003 due to entry of new firms into exporting equaled 9.3 percent. Since the corresponding loss in export growth due to the exit of firms equaled 7.8 percent, the net contribution of firm churning was 1.5 percent.
- The next set of rows accounts for the decision of existing exporters to enter new foreign markets (country entry) or to exit existing foreign markets (country exit). Entry into new markets accounted for 9.8 percent of export growth in 2002-2003, which was partially offset by exits (8.1 percent), leading to a net contribution of the destination country margin equal to 1.7 percent.
- The next set of rows depicts decisions regarding entry, exit and net contribution to the growth rate by HS2-digit level sectors. In 2002-2003, existing exporters contributed to growth of 5.4 percent by entering new sectors, but this contribution was more than offset 19.9 percent by exits, so that the net contribution to growth was negative by 14.6 percentage points.
- The net contributions of individual products, i.e. at the HS8-digit level carry the same logic, wherein the net contribution equaled 0.2 percent between 2002 and 2003.
- The sum of the net contribution of firm, destination country, sector and product extensive margin gives an overall extensive margin, which posted an 11.2 percent contraction for 2002-2003.
- The intensive margin illustrates the contribution of expanding the value of exports versus that of reducing it. The difference between these two dimensions equals the intensive margin, which was of 28.8 percent between 2002 and 2003.

134. The key results of the decomposition along export margins can also be viewed through visual inspection (Figure 30). The first observation is the expected result that firm churning, (entries and exits of firms from activity, from markets and from products), is associated with a positive selection effect: new entrants more than offset the loss in exports by exiting firms.⁶⁸ A closer inspection of the sub-components of the extensive margin suggests however, that the picture is less favorable.

135. First, churning along the destination-country margin was relatively stable over the 2002-2010 period, despite Pakistan's focus on bilateral and regional agreements. Despite various agreements entered, the country-extensive margin's contribution to export growth did not increase, providing some evidence that bilateral and regional agreements have not been effective in diversifying markets to the extent needed.

136. However, more importantly were the contributions of firm, sector and product margins of export growth which are key factors of export dynamism, particularly for countries under transition. New firms starting to export, existing exporters expanding into new sectors and existing exporters increasing their product offer within a sector, are key outcomes of a well functioning domestic market. Yet this positive effect on export growth is underperforming for Pakistan.

137. There has been a lower contribution of this product and sector margin to export growth than the contribution of the net expansion of firms into new destinations. This is in contrast to conventional analysis which sees the fixed costs of entry into a new market as normally higher than the fixed costs of expanding the product range. In other words, stronger economies of scale from

⁶⁸ International experience shows that export growth in developing countries takes place mostly at the extensive margin, as the reallocation of resources from less to more efficient firms and products is a main engine.

expanding the product range should translate in higher export growth contributions for the product extensive margin than for the market extensive margin.⁶⁹ In Pakistan, one sees the opposite.

138. In addition, the performance of export growth along these important firm, product and sector extensive margin has deteriorated over time. While quite dynamic along these margins at the beginning of the 2000's, since 2004, the export growth premium has decreased considerably. While the net contribution of the firm extensive margin to export growth are visible and broadly stable over time, it is the steep fall in the contribution of the product and sector margins that should be the primary concern to policy makers.

139. The ability to enter new markets is partly driven by entry costs and infrastructure in the destination markets and can be steered by trade policy measures. However, the ability to produce new exporters and their ability to venture in products or sectors rests on factors relating to the domestic economy's ability to generate growth through efficient resource allocation and creative destruction. The evidence and concern is that the export sector lost capacity to select high export growth sectors and products within sectors,⁷⁰ along with corresponding indicators that, since 2004, the ability of firms to innovate and select high growth products was greatly diminished.⁷¹

140. The crisis period of 2007-2009 saw a large fall in consumer demand in developed and emerging countries, and a subsequent fall in world trade. For Pakistan, on average fewer firms entered and exited the market and the period was associated with less churning, the net effect of firm churning continued to remain positive. This is the case across all dimension of export decomposition, (i) entries and exits by new firms, (ii) existing firms in new countries, (iii) sectors and products, all fell over the recession years. In addition, data for the latest period available (2009-2010) seems to indicate that Pakistani exporters have yet to recover from these effects of the recession years and that their performance continues to be less dynamic than in the pre-recession period.

141. Remarkably, while the extensive margin of exports has seen a fall over the recession years, the contribution of the intensive margin to export growths has rebounded and even grown—this despite performance of the intensive margin being varied over the years, with some years good and some not so. In recent years, the valuation effects linked to the cycle of commodities markets and the spectacular fall and recovery in foreign demand are likely contributors of Pakistan's performance at the intensive margin.

6. Conclusions

142. This chapter analyzed different dimensions of the trade performance in Pakistan. While the poor aggregate performance is a well known problem faced by the Pakistan economy, this chapter goes beyond it by exploring other dimensions such as the sophistication and quality of its export basket, diversification, and the survival rate of its export relationships. These analyses shed light on binding constraints to improved export performance.

⁶⁹ Arkolakis and Muendler, 2011.

⁷⁰ This is clearly visible from the trends over time for the following components of the extensive margin: export growth generated by the decision of exporters to expand their product range and to start exporting in a different sector of activity. However, it should be noted that the net effect is negative, leading to a lower contribution of these margins to export growth.

⁷¹ 2004 corresponded to a change in the trade policy strategy of Pakistan, whereby increasing complexity was introduced in the system. As noted, the lower numbers of firms entering the export activity with increasing survival rates over time also suggests the protection of incumbent exporters at the expenses of aggregate productivity and overall export growth.

143. Insufficient growth orientation of both products and markets and lack of sophistication of exports seem to be the main problems for Pakistan's trade competitiveness.

- In terms of orientation and growth, Pakistan is lagging behind the peer countries, as revealed by the trade to GDP ratio. The concern relies in the deterioration of Pakistan's position between the 1990s and 2000s. Furthermore, the export share over GDP shows a downward trend in the last years.
- A gravity model confirms that Pakistan is clearly under trading with emerging markets such as Brazil, India, Russia, Mexico, and principally with the neighboring India.
- The analysis also showed that there are problems of quality/sophistication in the export basket of the country. The sophistication of Pakistan's export basket is low and has increased at a very slow pace, mainly when compared to China and India.
- The product space analysis showed that there were 103 products with an RCA greater than 1 in both 1993 and 2008. These are mainly textiles and garment items such as linen, cotton, curtains, carpets, men's coats, and leather clothing.
- Even worse, indications coming from the unit values of some of these products, suggest that Pakistan exporters may be facing difficulties to catch up with the quality upgrading taking place elsewhere in the world. Moreover, there is no Pakistani export (with RCA >1) firmly embedded in the denser part of the product space.
- Regarding diversification, while still highly concentrated, Pakistan is showing positive signals both at products and market level. Even though the 65 percent of Pakistan's export value is concentrated in the textiles, apparel, leather, footwear, the share of extractive industries, metals, machinery and electronics and some agricultural products is increasing.
- There is some evidence of services exports, with growing rates in the period 2000-2007 over 15 percent average per year. But the export value of services remains low well behind the peer countries. There has been an increase at the margin in exports to the emerging BRIC bloc, also a good sign of diversification.
- The product space analysis suggests that, with some external facilitation, Pakistan has installed capacity to move readily into fairly sophisticated manufacturing industries. They include vacuum pumps, chemicals (acids), wheeled tractors, telecom parts, and food processing machines.
- Like many other countries Pakistan posts a high concentration of exports in the hands of a limited number of large exporters.
- The dominance of few exporters has increased over time and it seems associated with low rates of product innovation and experimentation and a low ability of the Pakistani export sector to enter into new higher growth sectors, as evidenced by the breakdown of export growth by margins.
- The fact that firms tend to export only a few products each may be a symptom of market distortions due to the dominant position of a few firms. This hypothesis is also consistent with

evidence that entry and exit rates are lower than in countries at a comparable level of development and that the overall extensive margin contribution to export growth is subdued.

- Export growth could be increased both by facilitating export activity and experimentation by large exporters and by reducing the sunk costs to start exporting for smaller firms or occasional exporters. The econometric exercise suggests that reducing the fixed costs and physical burdens to export may play a key role in boosting the export sector in Pakistan. A reduction of tariff complexity in Pakistan, may also have an important role.
- Larger exporters (defined in terms of volumes of exports or number of destinations reached or number of products exported) seem reluctant to change export strategies (it is these firms that are usually most responsible for performance at the extensive sector and product margin). Their success is mainly determined by developments at the intensive margin. This and the fact that they determine the bulk of exports suggest that determinants of developments at the intensive margin, including a macro-economic environment conducive to stability and growth and incentives to innovate, are important to ensure good export performance while reducing uncertainty and financing costs would spur innovation.
- As concerns smaller firms and exporters, the above results suggests that export values are likely to become larger the more continuous the interaction, whether within particular destination countries or within product categories.
- Hence, strategies helping the survival and/or deepening of exporting relationships of the smaller firms are also likely to be important as a determinant of export performance. These however should not be the result of eliminating competition domestically, but of more effective export support, technology transfer, learning and skill acquisition strategies.

Table 12. Trade Outcomes Assessment Summary of Key Findings

Policy objective	“Increasing export value of existing products across markets, and to specific markets across products”	“Increasing unit values of existing export flows”	“Maintaining export relationships, and minimizing loss of export value”	“Increasing export value from new markets and new products”
	Poor performance in terms of aggregate exports.	Sophistication of Pakistan’s export basket is low and has increased at a very slow pace.	Low survival of export relationships	New products and new markets have been incorporated in Pakistan’s exports (2002-07).
Policy challenges	Missing opportunities in terms of growing markets, including and especially in the region (India)	Unit value prices suggest difficulties to catch up with the quality upgrading	High rates of new firm entry and experimentation with new products	Much less dynamism observed since the crisis
	Lack of sustained product competitiveness (RCA)			Some progress on diversification into services

CHAPTER III: TRADE POLICY FOR EXPORT DIVERSIFICATION

A. Introduction

144. Based on the challenging competitiveness outcomes described in the previous chapter, there is a broad recognition that a new trade oriented strategy is required. Vision documents by the Planning Commission, including Vision 2030 and the recently adopted New Growth Strategy, recognize that strategic choices are needed to achieve sustainable growth. In the manufacturing sector, a rapidly changing and internationally competitive environment is requiring substantial rather than marginal changes across a number of activities in order to shift the production paradigm to include technology adoption and knowledge-based industrialization alongside the traditional low value-added, resource-driven activities which has driven Pakistan's export basket for the past half century.

145. One of the choices to be made is the need to confront policies which have created an anti-export bias that has kept Pakistan's trade orientation so low. Vision 2030 acknowledges that "The lack of diversification in Pakistan's manufacturing sector has been due to heavy protection granted to resource based industries, high rates of import duties on raw materials used in the machinery, equipment, and chemical industries, and zero or low rates of import duties on finished and semi-finished goods relating to these sectors. This is further compounded by widespread smuggling of all consumer durables. Many of these issues have been resolved to some extent through tariff rationalization in the last few years, but further fine tuning is needed to encourage investments in manufacturing".⁷²

146. This chapter will analyze some of the outcomes of Pakistan's trade policy, including effective protection, exchange rate bias, and other trade restrictiveness estimates utilizing a database of firm-level and customs transactions level data. In doing so, the study seeks to identify the source of these distortions and recommend measures to mitigate them in order to provide for *neutrality* in tax and tariff regime. The discussion also draws on strategies adopted by peer countries that have made significant progress in export growth and diversification.

147. Following a discussion of Pakistan's trade policy and trade performance from historical and comparative perspective as the starting point for the analysis, the chapter evaluates tariff policy and its inherent anti-export bias along with the associated exchange rate regimes. The chapter also provides a qualitative review of other policies, such as non-tariff barriers, export subsidies and non-trade measures. Based on the starting point and the lessons of trade reform from peer countries reforms, recommendations are provided along with the associated short-term impacts on fiscal revenue, imports and protection.

B. Trade, Tariff, Tax Policy in Pakistan: Evolution and the Current Regime

148. ***Early trade reforms: comprehensive, extensive and sustained.*** Pakistan made bold and swift reforms in the early part of the previous decade, reducing prohibitively high tariffs, reducing non-tariff and para-tariff measures, as well as exchange measures. A steady program of tariff reductions was adopted through a 'top down' approach, which brought down the highest tariff rates. The average tariff was reduced from 46 percent in 1997/98 to 20 percent in 2001/02 [through five-percentage point cuts] (Table 13). At the same time, the number of tariff bands was reduced

⁷² Pakistan in the 21st Centenary: Vision 2030, chapter 7, page 2.

gradually, from 14 to 4. By 2003, nearly all quantitative restrictions (QRs) were eliminated and the state owned enterprises that controlled imports and exports of some products were also eliminated.⁷³

Table 13. Evolution of Tariff Protection, 1997-2010

	1997/98	2001/02	2004/05	2006/07	2007/08	2010
1. Bound tariff lines (percent of all tariff lines)	n.a.	36.6	..	98.0	98.0	98.0
2. Simple average applied rate	46.0	20.4	16.8	15.0	14.5	14.9
Agricultural products			19.0	15.4	14.9	15.2
Industrial products			16.5	14.9	14.5	12.1
Textiles and clothing			21.7	19.4	19.3	18.4
3. Tariff quotas (percent of all tariff lines)		20.1	0.0	0.0	0.0	0.0
4. Domestic tariff "peaks" (percent of all tariff lines) ^a	n.a.	26.4	1.2	1.0	1.1	1.0
5. International tariff "peaks" (percent of all tariff lines) ^b	n.a.	0.0	52.0	41.5	40.0	36.0
6. Overall standard deviation of tariff rates	n.a.	0.9	11.9	11.3	11.7	15.8
7. Coefficient of variation of tariff rates	0.5	57.1	0.7	0.8	0.8	0.9
8. Duty free tariff lines (percent of all tariff lines)	n.a.	16.0	0.0	0.0	5.8	5.8
9. Non-ad valorem tariffs (percent of all tariff lines)	n.a.	0.8	0.6	0.7	0.6	0.6
10. Non-ad valorem tariffs w/ no AVEs (percent of all tar lines)	n.a.	0.0	0.6	0.7	0.6	0.6
11. Nuisance applied rates (percent of all tariff lines) ^c	n.a.	0.9	0.0	0.0	0.0	0.0

^a Domestic tariff peaks are defined as those exceeding three times the overall simple average applied rate.

^b International tariff peaks are defined as those exceeding 15 percent..

^c Nuisance rates are those greater than zero, but less than or equal to 2 percent. Calculations exclude specific rates and include the ad valorem part of compound rates. The 2001/02 tariff schedule is based on eight-digit HS96 nomenclature consisting of 5,477 tariff lines; the 2004/05, 2005/06, and 2006/07 tariff schedules are based on HS02 nomenclature consisting, respectively of 6,231, 6,336, and 6,803 tariff lines; the 2007/08 tariff schedule is based on HS07 nomenclature consisting of 6,909 tariff lines.

Source: WTO TPR 2002 for 1997/1998 data, WTO TPR 2008 for 2001 to 2008 data, 2010 calculated by authors using Pakistan's FBR data.

149. The early reforms attached a high priority to complementary reforms in both trading rules and exchange rate management. In the first case, reforms aggressively pursued an effective rules-based trading system and involved active participation in the Uruguay and Doha Rounds. As a result Pakistan increased bound tariffs considerably, leaving a large 'policy-space' and thereby reducing predictability of the trade policy.⁷⁴ Second, the early trade policy reforms were complimented with associated year by year currency devaluations, amounting to almost 100 percent in real terms between 1980/81 and 1996/97 and a further 20 percent over 6 years in support of the second phase of trade liberalization. In addition, apart from the real devaluations, the nominal rate was maintained in line with inflation differentials with Pakistan's principal trading partners. In contrast, from July 2008, the domestic inflation has surged, causing a steep month-to-month appreciation in the REER index which coincided with the increased protection in the system.⁷⁵

⁷³ World Trade Organization, Pakistan Trade Policy Report, 2008.

⁷⁴ 98 percent of tariff lines in textiles items were fully bound by 2008 and 0.8 percent are partially bound compared to the 36.6 percent that were fully or partially bound in 1998/99 (WTO, TOR 2008). However, most bindings exceed applied MFN rates and average bound levels amounts to between 3 to 4 or more times the averages applied rates, especially in agriculture where gaps are wider. Based on tariff bindings of Pakistan available at http://www.wto.org/english/thewto_e/countries_e/pakistan_e.htm.

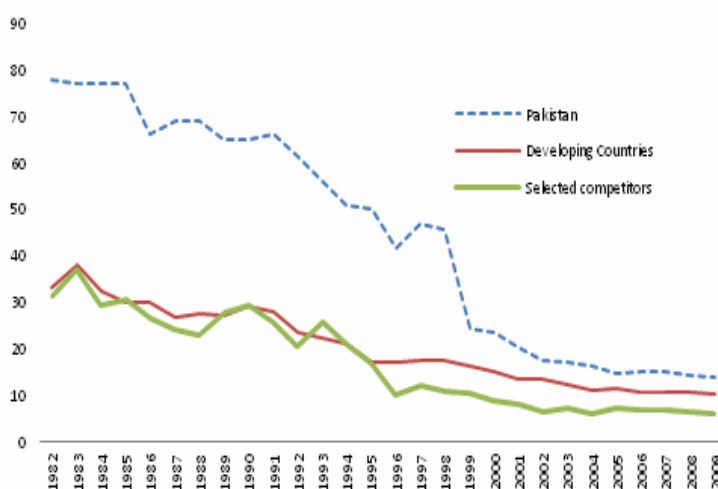
⁷⁵ "It is not a coincidence that the increases in the protectiveness of Pakistan's tariff system (including the new regulatory duties) occurred around this time". Purcell (2010) p.23.

150. Pakistan's other rigidities and macroeconomic difficulties may have muted the maximum impact from the reforms when weighing Pakistan's reforms against its peers and competitors.

151. *Reforms had impact.*

Merchandise trade-to-GDP increased from around 25 percent in 2000 to around 30 percent in 2005. In those years, export growth raised the capacity to increase imports, including capital goods and contributed to the GDP growth which rose to over 6 percent in 2004 and peaked at 8.4 percent in 2005. During the period 2001-08, exports in nominal US dollars increased by 110 percent. Furthermore, a simple measure of exports diversification—the Hirschman (H) index—suggests that Pakistan's export portfolio has diversified between 2000 and 2004 by a small but significant amount: moving from an HI index of 12.4 in 2000 to 10.9 in 2004.⁷⁶

Figure 31. Pakistan's MFN Unweighted Average, 1982-2009



Sources: UNCTAD TRAINS database and WTO IDB database (both through World Integrated Trade Solutions (WITS)).

Table 14. Simple Average Tariffs, Cross Country Ranking, 2008

Chile	1.4	7	38.5
Turkey	2.4	11	22.9
Mauritius	4.2	31	59.9
Costa Rica	5.5	42	46.9
Malaysia	5.9	44	112.9
South Africa	7.7	52	29.5
China	8.6	59	30.4
India	9.7	68	16.9
Lao PDR	9.7	69	31.9
Nigeria	10.7	75	42.5
Sri Lanka	10.9	82	33.3
Vietnam	11.7	90	63.9
Egypt, Arab Rep.	12.3	94	24.1
Pakistan	14.0	111	14.5
Bangladesh	14.8	113	16.2
Developing Countries (134)	9.3		29.1
Peer country sample	8.7		40.7

Notes: All tariff rates are based on un-weighted averages for all goods in ad valorem rates, or applied rates, or MFN rates whichever data is available.

⁷⁶ Hirschman (H) index, which is calculated using the shares of all 6-digit products in a country's exports: $H_j = \sqrt{\sum (x_i/X_t)^2}$ where x_i is country j 's exports of product i (at the three-digit classification) and X_t is country j 's total exports. The index has been normalized to account for the number of actual three-digit products that could be exported. Thus, the maximum value of the index is 239 (the number of individual three-digit products in SITC revision 2), and its minimum (theoretical) value is zero, for a country with no exports. The lower the index, the less concentrated are a country's exports.

C. Current Tariff and Trade Policy Regime: A Descriptive Analysis

152. *Tariffs remain a key trade and industrial policy tool in Pakistan*, as pointed out in recent studies and reviews,⁷⁷ and as such, the tariff structure and its deviations have a impact on how resources are allocated between sectors, industries and firms and are thus a fundamental determinant of Pakistan's trade competitiveness. While the reforms in the official tariff schedule described above are impressive and undoubtedly can be attributed to some temporary impact, only looking there masks much of the distortions and inconsistencies driven often by competing institutions and their policies. Instead, the diagnosis of *applied tariffs* instead aided by *micro-level* firm data (2005-2010) and customs transactions data (2009/2010) provides the central analysis for this section.

Table 15. Tariff Schedule by Stage of Processing, 2010

	<i>Consumer goods</i>	<i>Intermediate goods</i>	<i>Raw material</i>
Mean	20.4	10.8	9.5
Std. dev.	11.5	8.0	9.6

153. On an official level, Pakistan's structure of nominal tariffs has maintained an overall liberal open profile. The official tariff schedule shows 99.4 percent of tariff lines as *ad valorem* with 14 bands, ranging from zero to 150 percent and a simple average tariff level of 14.9 percent in 2010. The greatest frequency of official tariff lines occurs around 5 the percent slab while around 45 percent of the official schedule displays low tariffs, of 0 or 5.

154. However, in contrast to the relatively low tariff levels on average are some sector and product distortions. A large segment of agriculture goods are taxed at 35 percent generating a higher average of around 15.9 percent than industrial tariffs around 13.2 based on the government's official MFN schedule. The transportation sector maintains the highest nominal tariff levels, with some average rates reaching as high as 60 percent including 19 products that exceed 90 percent. In addition, though regulatory duties were being phased out at the time of Pakistan's last WTO Trade Policy Review in 2008, there are recent cases of additional duties being imposed and withdrawn while others remain.⁷⁸ In 2009, regulatory duties ranging from 15 to 50 percent on 379 luxury items including motor vehicles were imposed (but again have been removed).

155. In addition to the regulatory uncertainty coming from the use of tariffs as a revenue tool, the official customs schedule of average tariffs suggest a structural cascade with tariff escalating by stages of processing. Raw materials and intermediate inputs attract low tariffs, while tariffs on consumer goods are higher, twice as high in many cases—leading to amplified effective protection on the final product. The pattern is more prominent in consumer durable goods such as automotives and air-conditioning where inputs range from 0 to 10 percent and final goods as high as 60 percent, yielding relatively high levels of effective protection.

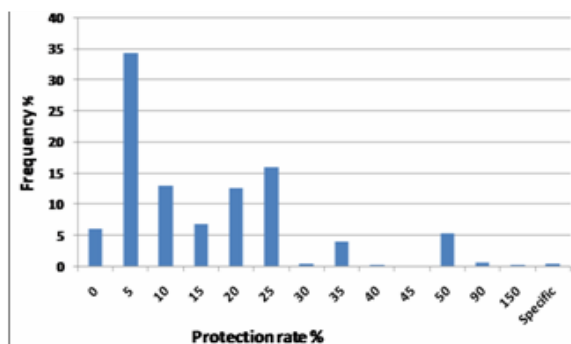
156. More importantly, the significant deviation of effective tariff rates from official rates reveals an underlying opaqueness and complexity of trade policy. A significant contrast between MFN and effective duty is observed in Pakistan. The official schedule suggests that custom tariffs have 14 slabs or bands (Figure 32), but in practice Pakistan's customs data for 2009/2010 at the 8-digit level

⁷⁷ (WTO TPR 2008, Pakistan's Strategic Trade Policy Strategy (2009-2012), and as reflected in the recent report by Purcell et. al 2011, commissioned by the Pakistan Institute of Growth, which devoted much of its analysis on implications and institutional mechanisms for determining import tariffs in Pakistan.

⁷⁸ For example, a 35 percent regulatory duty was imposed on raw sugar but recently withdrawn in September 2010; a 25 percent duty on potatoes from India was introduced and withdrawn in 2009; and a 5 percent regulatory duty was placed on pigment and acrylic thickeners in 2010 after the 2009/10 budget reduced the duties to zero.

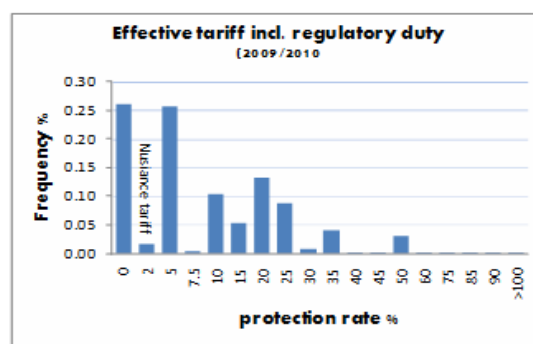
reveals that it applied some 40 different rates. Moreover, when rounding up these discreet rates to the nearest 5 percentage point show that actually, there are over 20 different applied bands. At the individual tariff line level, over 55 percent of the applied tariffs are either 5 percent or less compared to the 40 percent in the official schedule. The rest display a large share over 20 percent. Some of the important deviations are due to duty drawback systems and concessions stemming from specific bilateral and multi-lateral trade arrangements. However, much of the deviation can be attributed to discretionary firm, industry and sector specific application of the official tariff policy.

Figure 32. Distribution of Tariff Rates, by Frequency, 2009-2010



Source: Purcell et. al.(2011).

Figure 33. Effective Tariff, including Regulatory Duties, 2009-2010



Source: Author's calculations.

157. In addition, when examining actual trade transactions, at least 2 percent levy a rate between zero and less than 2 percent, tantamount to “nuisance taxes” adding to the cost of businesses, increasing the administrative burden of collecting them and often outweighing the benefit from the marginal revenues.⁷⁹ Some 122 transactions covering 30 different items have resulted in applied duty rates above Pakistan’s bound rates, with the majority of such transactions (82) related to HS code 370610 (Motion-picture film, of a width of 35 mm or more).⁸⁰

158. Deviations due to exemption and regulatory duties occupied half of the published schedule accompanied by a complex web of taxes and duties, as well as reductions and exemptions granted under various Statutory Regulation Orders (SROs)—principally three for industries: SRO regimes 565(1)2006, 567(1) 2007 and 575(1), accounting for 23 percent of Pakistan’s imports in 2009/2010 (Box 3 and Table 16). On average, firms or industries received concession of around 11 percentage points from the non-uniform application of statutory rates under one of these three SROs.

⁷⁹ Pitigala and Hoppe, 2010.

⁸⁰ HS 370610 is bound at 50 percent, while applied tariffs on many transactions are more than 60 percent and some are as high as 115 percent.

Box 3. Exception to MFN Regime: Three Key 2006 SROs

The Ministry of Finance/CBR issues Statutory Regulation Orders (SROs), which are approved by the Economic Coordination Committee of Cabinet. Most SROs provide exemptions or partial exemptions from normal tariffs, but others provide for increased tariffs subject to at least one special condition announced in an SRO. The EDB administered SRO's mostly provide exemptions for inputs and are confined to specified firms or groups of firms and are not available to other particularly commercial importers. Three key SRO administered for the objective of indigenization or domestic orientation for industry development are SRO 565(I)/2006, SRO 567 (I)/2006 and SRO 575(I)/2006.

SRO 565(I)/2006 ("Survey based") provides a 45 page list of 154 domestically manufactured products. For each of these products there is an associated list of inputs ("raw materials, sub-components, components, sub-assemblies, and assemblies") which can be imported at specified low customs duty rates-mostly zero, 5 percent or 10 percent.

SRO 567 (I)/2006 ("Non-survey based") provides a 28 page list of products for which the normal statutory customs duties have been reduced, mainly to zero or 5 percent, but others (e.g. various textile and garment products) to 3 percent, 6.5 percent and 9 percent. Listed products are organized by industry e.g. Sl. 4 consists of 33 inputs for the poultry sector. There are similar groups of surgical, textile and clothing, and pharmaceutical products.

SRO 575(I)/2006 similarly gives a long (about 40 pages) list of machines & "capital goods" for which the normal customs duty is reduced, nearly all to either zero or 5 percent. Machines listed in SRO 575 are listed by user industry (e.g. machines for horticulture). Many of these machines are specialized and probably do not have uses outside the user industry, others (e.g. gen-sets) certainly have alternative uses.

Source: Purcell, 2011.

Table 16. The Statutory and Effective Duty Regime Based on Customs Transactions, 2009/2010

	Statutory	Effective	Mean	Std. Dev.	Mean	Std. Dev.	Min	Max
Total	1.00	1.00	0.15	0.13	0.04	0.11	0.00	1.86
Regulatory Duties	0.10	0.10	0.21	0.12	0.07	0.06	0.00	2.96
SROs 565, 567 and	0.23	0.08	0.14	0.08	0.03	0.02	0.00	0.3
FTA related	0.06	0.04	0.15	0.10	0.06	0.08		
Other SROs	0.08	0.02					0.00	0.97
Other, under	0.57	0.76	0.14	1.60				

Note: Statutory Duty is the ad valorem rates of regulatory duty (mean and Std. Dev.), whereas Effective Duty is the additive to the statutory rate, in this case by about 7 percent on average. Regulatory duty applied across all categories explains Share of Imports sum exceeding 100.

159. Furthermore, 12 percent of transactions covering 10 percent of imports in 2009/2010 were subjected to regulatory duties, adding around seven percent to already high statutory rates. Cases existed where regulatory were as high as 100 percent and special duties were up to 35 percent (mostly applied to finished goods and consumer durable goods), further amplifying the cascade along stages of processing. Moreover, the duties issued through SRO of the CBR and notified in the official Gazette are not consolidated in the tariff schedule or any published format.⁸¹

160. Application of the SROs approach to trade policy has been selective, highly biased and distortionary since in most cases they led to exemptions for inputs for specified firms or groups of

⁸¹ Transactions data in 2009/2010 suggests that *de facto* applied tariff exceeding bound levels being applied for a number of product lines by as much as 3-4 times, departing from agreed norms under Pakistan's multilateral commitments (section 18(5) of the Customs Act) and the 2007/08 Budget amended legislation preventing "regulatory duties" being applied which would exceed Pakistan's multilateral commitments (WTO, TPR).

firms.⁸² In particular, 44 percent of all SROs targeting exemption were on machinery and appliances sector where Export Development Board's (EDB) indigenization program was most active. By confining to selected, established firms and barring others, in particular commercial importers, such exemptions act as a *de facto* licensing scheme (Purcell 2011). Machinery and equipment also had the largest share products with regulatory duties (22 percent), mostly targeting finished goods and providing for high levels of effective protection within the sector.

161. The exemptions under SRO (565, 567 and 575) also extended to chemical and allied industries, automotive, rubber and plastic industries as well as agriculture. Within the sector, incidence varied considerably. Furthermore, optical photography and products with technological, capital-intensive products have low mean tariffs but the largest share of exemptions (30 percent). In contrast, footwear were virtually free of exemptions but with high tariffs.

D. The Nature of Distortions From Tariff Policy

162. A significant feature of Pakistan's trade policy is the dispersion in Pakistan's tariff structure. Apart from the statutory structure, customs data from 2010 indicates significant divergence in tariff paid across commodities, industries and between statutory and applied rates. Taking all tariff lines, the statutory tariff structure has an-weighted value of 14.5 percent with the Gini index equal to 0.426 (Table 17). The variance of statutory tariffs varies significantly across industries with services facing the most, albeit with low rates, and footwear/headgear facing the most uniform tariffs. The effective rates in Pakistan are even more unequally distributed with the Gini coefficient value of 0.498 overall and at the sector level, generally higher levels of inequality, demonstrating the fact that exemptions largely exacerbate the already high variation in the official schedule.

Table 17. Average and Dispersions of Statutory and Applied Rates by Sector, 2010

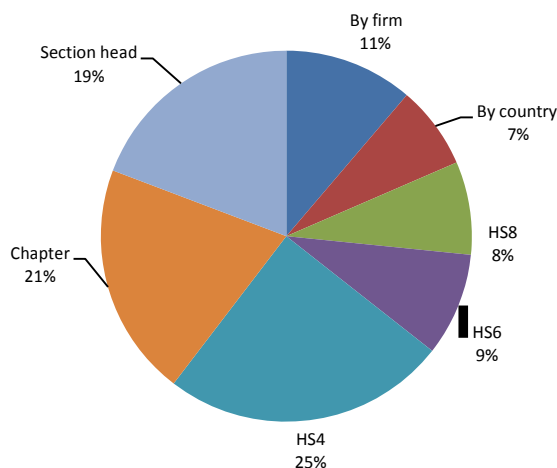
		Statutory	Applied	Statutory	Applied
		Rate	Rate	Gini	Gini
Service	36	0.955	0.4	0.954	0.4
Raw hides, skins, leather and furs	80	0.554	10.7	0.685	6.2
Vegetable products	309	0.507	11.7	0.55	9.3
Mineral products	116	0.498	11.7	0.514	6.5
Animal and animal products	157	0.459	7.7	0.51	10.7
Machinery/electrical	1,188	0.442	12.1	0.509	8
Transportation	481	0.392	14.9	0.482	20.5
Chemicals and allied industries	1,039	0.384	8.8	0.472	6.9
Metals	201	0.359	34.5	0.453	9.5
Miscellaneous	696	0.357	13.6	0.452	11
Stone/glass	258	0.326	14.9	0.419	15
Wood and wood products	196	0.319	27.7	0.401	12.2
Plastics/rubbers	300	0.313	16.7	0.399	13.2
Foodstuffs	212	0.286	20.4	0.38	19
Textiles	798	0.217	18.8	0.377	14.1
Footwear/headgear	51	0.056	22.9	0.143	19.8

⁸²While most pertained to exemptions or partial exemptions from normal tariffs, others provided for increased tariffs (see Purcell et.al 2011).

163. Tariff dispersion of this magnitude can be problematic on two fronts. First, high within and between sectors variations introduce relative price distortions that can worsen the resource misallocation induced by tariffs. Efficiency gains from low average tariffs are limited by wide disparities. Second, escalated structures, protecting the market for processed products rather than for primary products is an obstacle to organic economic development.⁸³

164. Determination of tariffs is a key consideration for setting policy especially tariff policy. A decomposition⁸⁴ of tariff variability suggests that about 19 percent is determined at the HS section level, 21 percent at the chapter level and 25 percent at the heading level. A much smaller share of total variation (17 percent) is caused by differentiated tariffs below the heading level. Most importantly, 18 percent of applied tariff variability is caused by the use of exemptions, mainly at the firm level demands (11 percent) than country level (7 percent) (Figure 34).

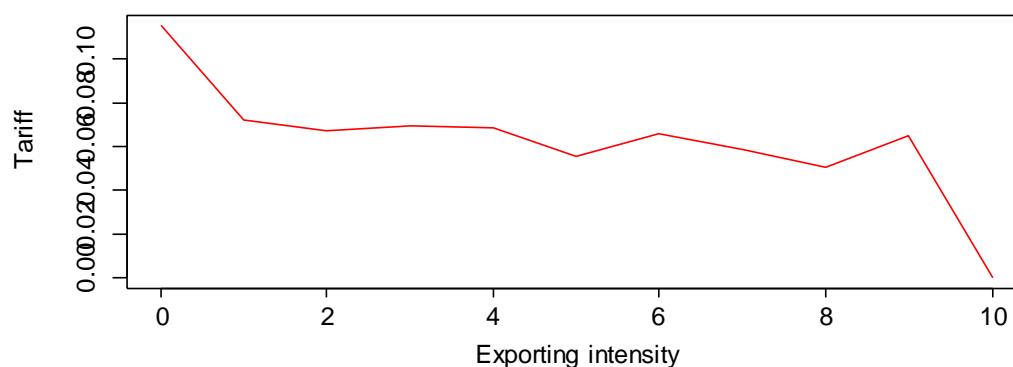
Figure 34. Decomposition of Tariff Variation



Source: Author Estimates.

165. ***Those who export intensively pay little or no tariffs while non-exporters bear the brunt of the tariff burden.*** The average applied tariff paid is related to export intensity and are inversely related. At the extreme end, exporters with highest intensity pay virtually no tariffs due to duty drawback and export processing zone regimes under which many of these exporters operate. At the other end of spectrum, being a non-exporter in Pakistan subjects one to relatively high tariffs. The key implication is that, barring exemption to domestic-oriented manufacturing industries under EDB administered program, small scale domestic manufacturers, indirect exporters, informal traders and consumers bear the burden of tariffs.

Figure 35. Tariffs by Export Intensity, 2005 -2010



⁸³ Antimiani (2004).

⁸⁴ Using standard regression analysis, the variance in observed tariffs is decomposed into exemptions applied to countries at the tariff line level (e.g. as a result of a trade agreement) and the remainder - considered as exemptions given to firms. Extending the analysis to levels of aggregation ascribes industrial or commodity preference.

Box 4. Insights from Firm Level Data: The Economic Determination of Tariffs

Duty exemption for firms suggests that level of tariff is a strong determinant of receiving exemptions. Using firm level trade data from firms' customs data on tariffs and exemptions, the probability that a firm imported a particular good with a duty exemption is based on the firm's overall imports, exports and the overall imports of the particular good by the given firm. Additionally, one can control for the good type at the HS eight-digit level, estimating the following regression:

$$\text{Duty Exemption}_{it} = \alpha + \beta_1 \text{Commodity}_i + \beta_2 \text{Firm}_i + \beta_3 \text{Export Intensity}_i + \beta_4 \text{Import Intensity}_i + \beta_5 \text{Value}_i + \beta_6 \text{Rank}_i + \beta_7 \text{Rank}_i + \beta_8 \text{Rank}_i + \beta_9 \text{Rank}_i + \beta_{10} \text{Rank}_i + \epsilon_{it}$$

Where Commodity_i is a dummy representing a given commodity at HS eight-digit level, Firm_i is a measure of a firm's export intensity equal to the rank of the firm's exports among other exporters (zero if not an exporter), $\text{Export Intensity}_i$ is a measure of firm's import intensity defined analogously, $\text{Import Intensity}_i$ is the value of the imports of a given good by a given firm, and Rank_i represents the average tariff rate for the importation of a given good.

The results for the key parameters (all except dummies) are shown below suggesting that the level of tariff is the strongest determinant of whether a firm may get a duty exemption and with a *higher tariff the probability is significantly lower*.

The value of the import is also very important determinant and *exemptions are more likely when the import values are greater*. Finally, the results show that the position of the firm as an importer or exporter is an important determinant too—firms that are larger importers are less likely to obtain an exemption while firms that are among the greatest exporters are significantly more likely to obtain an import duty exemption.

Estimated key logit parameters

	Coefficient	P	Chi-S	significance
Tariff	-1.22	0.50	-2.44	*
Log of import value	0.21	0.02	12.09	***
Rank of firm's imports	-0.18	0.01	-12.40	***
Rank of firm's exports	0.21	0.01	24.31	***
R2	42.5%			
N	11,568			

166. *Pakistan has a poor rating in its Overall Trade Restrictiveness Index (OTRI)* compared with selected competitors. While, complex to calculate, especially due to tariff and trade taxes in Pakistan, analysis of trade restrictiveness, which captures widespread exemption affecting imports and other policy barriers⁸⁵ is useful in understanding the institutional and political determinants of trade protection. The OTRI provides a common metric of trade restrictiveness.⁸⁶

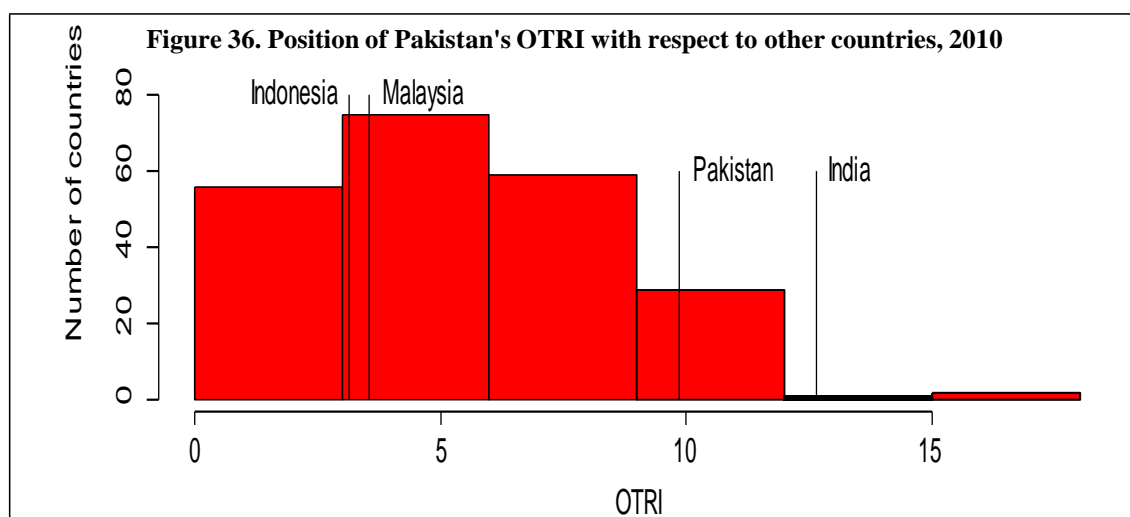
167. This point is illustrated in Figure 36, which depicts the distribution of observed OTR indices for all countries in the world and marks the position of Pakistan and some of its main competitors.⁸⁷ The

⁸⁵ For example, imports subject to high protection rates are likely to be small and therefore will be attributed small weights in an import-weighted aggregation, which would underestimate the restrictiveness of those tariffs. In the extreme case, goods subject to prohibitively high tariffs have the same weight as goods subject to zero tariffs: a zero weight. Similarly, when computing simple average tariffs, very low tariffs on economically meaningless goods would downward bias this measure of trade restrictiveness. Kee et. al. 2008.

⁸⁶ OTRI measures from a perspective of uniform tariff equivalent of observed trade policies on a country's imports – that is, the index shows the uniform equivalent tariff that would maintain the country's aggregate import volume at its current level (given heterogeneous tariffs).

⁸⁷ Following Kee, Nicita and Olarreaga (2008) one can estimate the overall trade restrictiveness indices (OTRI) using the latest GTAP database (version 8, base year of 2007) and the current GTAP model (Hertel 1997) for Pakistan and other countries in the world. The main source of data for Kee et. al (2008) is the WTO's Integrated Database, and UNCTAD's TRAINS, the base year is 2003 or 2004. Despite the differences in source of data and base years the results showed in Annex table 2 compares well with Kee, et. al. (2008) with the correlation coefficient of 0.5. There also significant differences between the two estimates which can be attributed to the differences in source of data and the base years (Kee

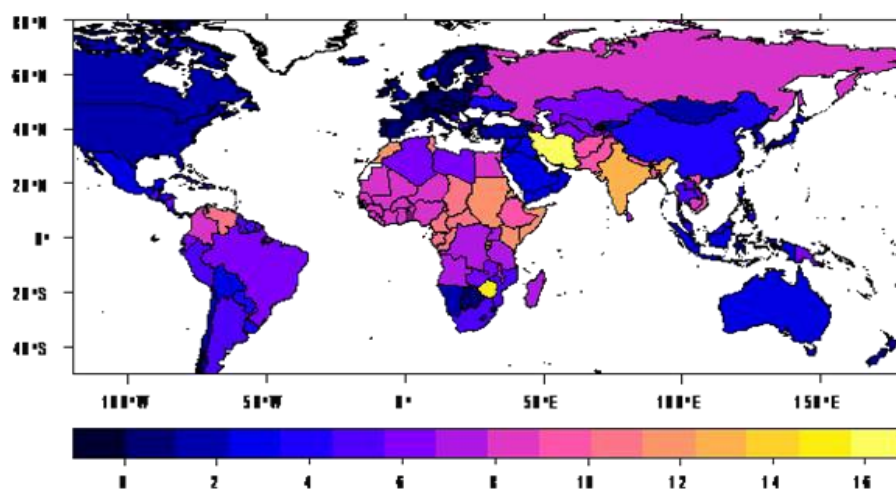
overall trade restrictiveness index of Pakistan places it at the 88th percentile only surpassed by the restrictiveness of India and Iran, the value of 9.9, making it one of the most protected countries in the world. Compared with OTRI results in 2004 (9.1) in Annex 2, a slight upward bias, worsening of Pakistan's overall protection is reversing some of the early progress towards reforms.



Box 5. Estimated OTRI for the World, 2010

The estimated levels of OTRI for the world are presented below and suggest notable difference between trade restrictiveness of world's regions.

- The most restrictive countries of the world appear to be Iran and Zimbabwe with OTRI index values around 16 percent. They are followed by India and a number of countries of central and western of Africa.
- The least restrictive countries are found to be Hong Kong and Taiwan, followed by the member countries of the EU and most of other developed countries.



et. al. 2009, adopting 2003-2004 base year) as well as the current approach incorporating unprotected services omitted from Kee et. al. (2009).

E. Analysis of Anti-export Bias of the Tax and Tariff Regime

168. *Structure of Nominal Rates leads to High Rates of Effective Protection.* Effective Protection (ERPs) estimates⁸⁸ is an analytical tool that enables the quantification of the magnitude of incentives provided for domestic traded goods production arising from the tariff structure.⁸⁹ In examining the summary of Pakistan's tariff protection, Table 18 shows that the general tendency for Pakistan tariff structure to be relatively low for capital goods and raw materials and higher for finished goods, causing an increase in the ERP.⁹⁰ Thus, sector level measures of ERP in import substituting industries such as beverages, tobacco and motor vehicles and accessories, vegetable oils and fats yields very high effective protection estimates in the region of 100 percent or more compared with raw material and products of intermediate stage. There is also large negative protection on services, establishing a clear distinction from industry.

Table 18. Structure of Pakistan's Protection, 2010

Paddy	10.0	10.5	Wood products	15.2	19.3
Wheat	10.0	10.7	Paper products, publishing	15.8	21.4
Cereal grains nec	4.0	0.5	Petroleum, coal products	8.0	24.6
Vegetables, fruit, nuts	12.2	14.5	Chemical, rubber, plastic	9.9	11.5
Oil seeds	2.7	2.3	Mineral products nec	19.3	26.6
Sugar cane, sugar beet	5.0	2.9	Ferrous metals	10.3	11.6
Plant-based fibers	0.0	-4.0	Metals nec	6.9	4.2
Crops nec	4.8	3.6	Metal products	17.8	47.0
Cattle, sheep, goats, horses	2.1	-3.3	Motor vehicles and parts	38.7	115.0
Animal products nec	7.8	8.7	Transport equipment nec	14.6	17.3
Raw milk	0.0	-5.0	Electronic equipment	9.2	10.1
Wool, silk-worm cocoons	3.3	-0.8	Machinery and equipment	10.1	11.3
Forestry	6.1	5.5	Manufactures nec	15.3	39.7
Fishing	8.8	9.3	Electricity	0.0	-9.0
Coal	3.3	1.5	Gas manuf / dist	5.0	4.2
Oil	7.5	8.7	Water	0.0	-2.0
Gas	0.0	-1.6	Construction	0.0	-10.0
Minerals nec	6.6	5.8	Trade	0.0	-1.1
Bovine meat products	6.5	5.3	Transport nec	0.0	-7.9
Meat products nec	21.8	33.3	Water transport	0.0	-2.8
Vegetable oils and fats	11.3	151.8	Air transport	0.0	-3.1
Dairy products	23.1	63.7	Communication	0.0	-2.2
Processed rice	10.0	17.6	Financial services nec	0.0	-3.2
Sugar	10.7	17.0	Insurance	0.0	-0.6
Food products nec	16.4	121.5	Business services nec	0.0	-3.5
Beverages and tobacco	57.4	390.0	Recreational	0.0	-5.2
Textiles	16.4	57.1	Public Administration	0.0	-2.5
Wearing apparel	24.1	66.7	Dwellings	0.0	-2.2
Leather products	15.7	190.1			

Sources: Author's calculation.

⁸⁸ Corden, 1971; and Greenaway and Milner, 2003.

⁸⁹ It examines the relationship between tariffs on the final product and on its input-supplying sectors through input-output linkages and provides a sense of the "breathing room" for absorbing reductions in rents from protection.

⁹⁰ $ERP_m = (VAm_j - Vaj \ YVA_j)$ where VAm_j is industry j 's value added at domestic prices and Vaj 's value added at world prices. VAm_j and VA^* are computed as $VAm_j = VO_j - X \ INT_{ij}$ and $VA^* = VO/(1 + t_j) - I \ INT_j/(1+t_j)$.

169. The results reinforce the potential for resources to be driven towards production for the domestic market and away from firms competing for export markets. Firms that produce for export market such as wood and electronic products, have relatively low effective protection estimates, and are unable to benefit from exemptions of import duties. The effect of tariffs on firms is invariably negative, because the cost-increasing effects of higher prices for intermediate goods are not offset by benefits on output prices. EDBs use of exemptions and regulatory duty to achieve indigenization objectives largely explains the higher effective protection in a number of manufacturing activities, particularly the automotive sector. As expected the raw material on textile industry provides negative protection, the production increases or exports are less likely to take place under these circumstances.

170. ***The pattern of protection is correlated against two performance indicators:*** Value added and Export Performance (Figures 37 and 38).⁹¹ In the first case, the effective protection is correlated with low value added activities by definition, so that low tariff on final goods can lead to increased returns to value added. As a result, sectors with high effective rates of protection tend to have low value-added or conversely there is a higher incentive to produce low-value added which sums up the inherent bias against the export competing sectors. Similarly, reviewing effective protection against industry export performance suggest that the sectors that have achieved strong export performance face low levels of effective protection, while sectors with high level of effective protection have weaker performance.

171. ***A substantial resource-pull effect towards domestic oriented manufacturing is evident from industry and firm level ERPs.*** Industry and product level ERP measures demonstrated the resource pull toward protected sectors, where there are incentive to produce domestic oriented manufacturing—especially where EDB administers SRO's and exemptions. Here in the sectors which are the most active use of EDB incentives, such as refrigerators, air-conditioners and deep freezers, rates are between 65 percent and 150 percent, while cotton yarn has rates about 5 percent (Table 19).

Figure 37. ERP and Value Added

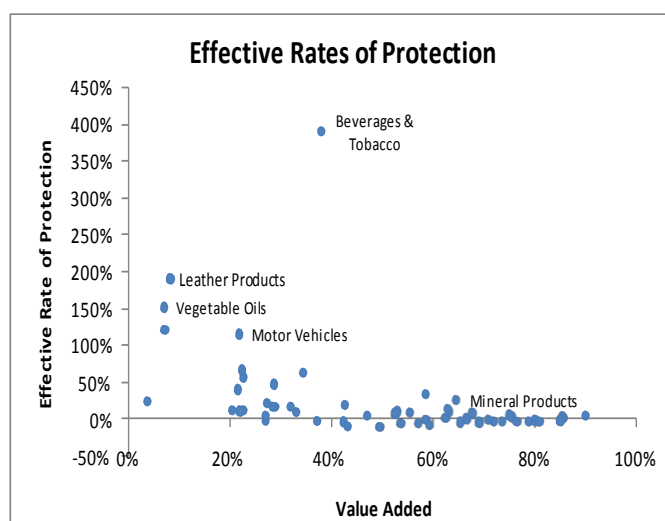
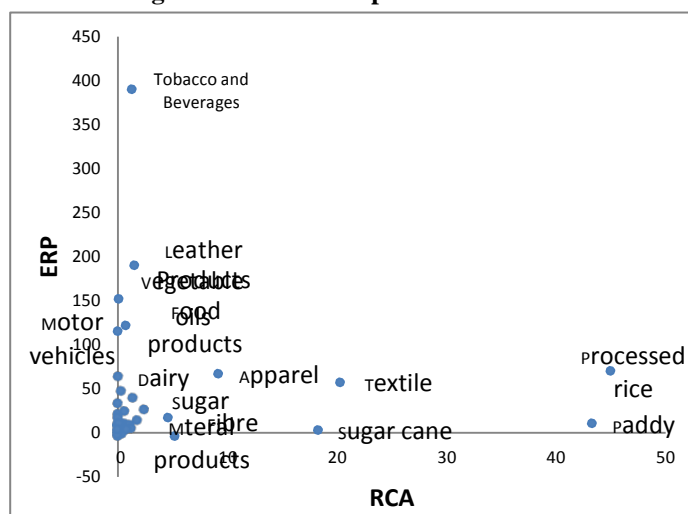


Figure 38. RP and Export Performance



⁹¹ Following Balassa's (1965) measure of relative export performance summarized as RCA, defined as a country's share of world exports of a good divided by its share of total world exports. The index for country i good j is $RCA_{ij} = 100(X_{ij}/X_{wj})/(X_{it}/X_{wt})$ where X_{ab} is exports by country a (w =world) of good b (t =total for all goods).

Table 19. An illustrative sample of firm level ERPs, 2010

Produ ct	Nom inal Prote ction	Effe ctive Prote ction	VA % O utpu t
Laundry Soap	50	343	12
Split type AC 1 ton	50	150	26
Refrigerator 193L	50	109	41
Refrigerator 323L	50	106	42
Split type AC 1.5 ton	50	101	41
Refrigerator 343L	50	97	46
Refrigerator 249L	50	92	49
Soft Drinks in 330ml Cans	50	92	49
Refrigerator 259L	50	92	49
Refrigerator 367L	50	92	49
Refrigerator 224L	50	91	50
Refrigerator 274L	50	91	50
Refrigerator 215L	50	91	50
Refrigerator 292L	50	88	51
Refrigerator 421L	50	88	52
Split type AC 2 ton	50	83	52
Golden Sweet Corn	50	78	64
Garden/Chick Peas	50	77	65
Tomato Puree	50	74	67
Fabrics	25	73	34
Deep Freezers 8CF	50	68	70
Deep Freezers 18CF	50	67	71
Deep Freezers 10CF	50	67	72
Deep Freezers 12CF	50	65	73
Deep Freezers 14CF	50	65	74
Jam, Jelly and Marmalade	50	59	85
Pickle	50	54	92
Mint /Coriander Chutney	50	54	92
Squash	50	54	92
Sauces and Ketchup	50	53	95
Mango/Plum Chutney	50	52	95
Milk Chocolate	50	51	98
Guar Gum Powder	25	25	24
Canned food	15	25	61
Punching bags, Gear Bags	20	23	87
Ginger/Garlic Paste	15	16	93
Yarn of artificial staple fibre	10	11	82
Cotton Yarn	5	8	62
Blended Cotton	12	10	58
Cotton Yarn carded	8	4	51

F. The Presence of Anti-Export Bias From Exchange Rate Management

172. *Overvaluation may be detrimental to achieving the strategic trade policy goals.* Since May 1999, Pakistan has maintained a competitive exchange rate regime as a key outcome of the macroeconomic policy mix. As noted above, the 1996 - 2003 trade liberalization episode was supported by further real exchange rate devaluation of about 20 percent per annum over this period (Figure 39) and was further maintained in line with inflation until 2004. After that, the rupee appreciated in real terms until 2008. Since July 2008, domestic inflation caused an appreciation in the REER index resulting in a loss of competitiveness in recent years (and a domestic lobby for high protection). Looking ahead, the need to maintain exchange rate flexibility and strengthen external competitiveness has become even more important given a volatile external environment.

Figure 39. Normal and Real Effective Exchange Rates, 1999-2009

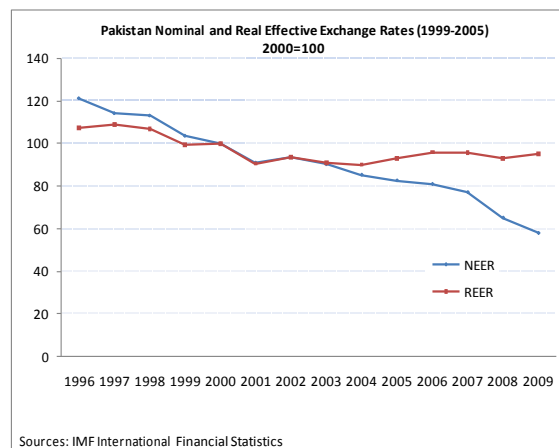
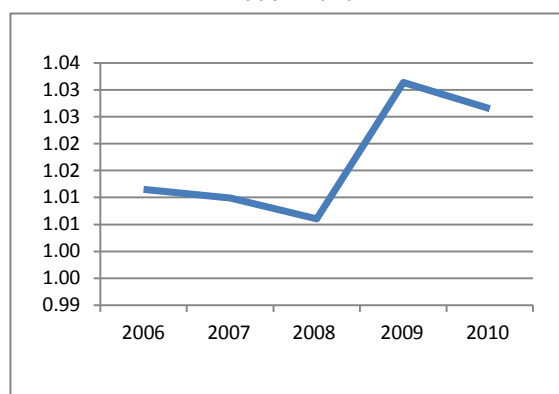


Figure 40. Anti-Export Bias in Exchange Rate, 2006 - 2010



173. An indicator of anti export bias is the ratio of (average) effective exchange rate for imports (EERm) to that of exports (EERx). If the ratio EERm/EERx is above unity, a bias against export activities is suggested.⁹² In Pakistan's case, there has been a significant reduction of anti-export bias from 2003-2004 from 1.18 to around 1.03 around 2008 (even with the appreciation. But as shown in Figure 40 the trade regime still retains anti-export bias in effective exchange rates.

174. The need for a competitive real exchange rate is not unrelated to the rates of protection. Lowering protection invariably eases the anti-export bias in real exchange rates but needs to be compensated with a corresponding devaluation.⁹³ A principal reason is that tariffs appreciate the real exchange rate, which makes exporting less attractive to importing. With protection varying between sectors providing relatively high protection on some sectors and low on others, the burden of the exchange rate adjustment will be disproportionately borne by unprotected sectors especially exports where the effective protection is relatively low.⁹⁴

⁹² EERm indicates the domestic currency cost of one unit of foreign currency (US\$1, in this case) worth of imports. For exports, EERx represents the exchange rate after adjustment for the existing export promotion schemes, such as subsidized export credits and freight subsidy. Thus, EERx represents domestic currency equivalent of proceeds from exports worth one unit of foreign currency. (World Bank 2007).

⁹³ As "Lerner" symmetry theorem would suggest imposing a tax on imports has an equivalent effect on exports Shephan Tokarick (IMF, 2006) exploring the notion finds that for many developing countries, the magnitude of the implicit tax is substantial—about 12 percent, on average, for the sample countries studied.

⁹⁴ (see Shatz and Tarr 2000).

G. Other Measures Affecting Trade

175. While tariffs are the primary trade policy measure in Pakistan, non-tariff barriers and other trade policy measures remain important. The section compiles the principal policy measures and provides brief description of each. Three broad areas are described: (i) direct restrictions on imports, (ii) measures to refund import duties, and (iii) direct export incentives.

176. **Import Bans, Quantitative Restrictions.** Specific quantitative restrictions have been almost completely phased out, apart from certain ozone-depleting substances, but some potentially negative non-tariff measures and processes remain in place. The Government can prohibit or restrict imports by notification if deemed in the "public interest," as contained in the Ministry of Commerce's annual Import Policy Order. More specifically, there are prohibitions and restrictions for religious, health, safety, environmental and/or national security concerns.⁹⁵ The Import Policy also identifies a number of goods that are subject to testing, certification and/or procedural requirements, most of which are on health and safety grounds. However, there are some particular restrictions which do not fall within these categories, including the ban of some specific pharmaceutical compounds, and used and retreaded tires.

177. More importantly, restrictions imposed on import of second-hand machinery and equipment as part of the Import Policy is motivated by protection of local industries. The Strategic Trade Policy Framework, 2009-12 provides for a standard-based system for the import of previously-used specialized machinery, in place of the ban on second-hand imports, which will facilitate greater access to capital equipment. The import ban on used machinery and equipment has been relaxed. In some cases, imports of raw materials are restricted to manufacturers, such as crude palm oil and certain pharmaceutical compounds. Notably, a number of motor vehicle components fall into this latter category, as well Imports from Israel (but not exports) remain prohibited but those from India are progressively being allowed.

178. **Import Licensing—De jure & De facto:** Pakistan continues to apply a number of measures which can be argued as contravening the TRIM Agreement that distorts markets and has a cost on both the importer and exporter.⁹⁶ The *de jure* licensing which does occur are operated for health, safety, security, religious, and environmental reasons. The *de facto* system however, is more important and uses the system of import quotas and tariff exemptions/concessions requiring ministerial or other approval (e.g. certain chemicals and refrigerated trucks). In particular, the prominence of the Export Development Board's discretionary control over materials and components imported under SRO exemptions is based on a list of products maintained under CGO 11/2007⁹⁷ that bars such concessions. EDB had discretionary control over new entrants to the industry, since all potential entrants would need to negotiate with EDB and agree on an individual indigenization program and how that would be phased-in over time. There are

⁹⁵ While standards are increasingly following international requirements, they are applied uniformly to imports and domestic goods, and are mainly voluntary. Two thirds of its 27,000 national standards are aligned to international standards (e.g. ISO). However, SPS administration is complicated by many agencies, overlapping responsibilities and duplicate roles. As well, Pakistan has no uniform labeling and marking system. Only specified food coloring can be imported. Imported foodstuffs, including ingredients, must have at least 50 percent of the original shelf life left on importation.

⁹⁶ These measures eludes conventional measures often NTB incidence of total tariff proposed by Erzan et. al. (1989) and Laird and Yeats (1988) or the price wedge measures (Hinkle, 2009).

⁹⁷ As an exemption to the extensive exemption oriented SRO (565, 567 and 575), there are 906 products published under CGO 11/2007. There is one local monopoly producer of 91 percent of the listed products under CGO and the possibility that for some listed products small scale and informal sector producers are not counted. Purcell, Khan and Gulzar (2011). See the list of CGO 11/2007: <http://www.fbr.gov.pk/Docs/2010113141132597032007CGO11.pdf>.

also quotas on imports of certain goods eligible for tariff exemptions/concessions over and above SROs discussed above which operate effectively as tariff quotas and help transfer rents to the first in the queue.

⁹⁸ On a country basis, there are also some bilateral tariff quotas on tea, betel nuts, and certain clothing with Sri Lanka, and reportedly on certain textile products with Mauritius under respective FTAs. Importantly, Pakistan recently granted MFN status to India and abolished the positive list approach, following an increasing positive list.⁹⁹

179. The key implications of this often competing dual SRO/CGO regime—the former, an exemption and the latter, an exception to the exemption—is that it effectively constitutes a de jure ‘import licensing’ system. As such the negative impact on resource allocation is similar to any import licensing scheme: (i) exacerbates rent-seeking behavior, (ii) imposes price distortions through varied effective protection rates for different firms, and (iii) loses the opportunity for additional government revenue. In addition, the specific EDB indigenization program systematically bias against the small industry and the commercial trader, as these are assessed based on existing or proposed industry activity with stipulated inputs and their quantities.

180. ***Duty Drawback and Suspension Schemes.*** The CBR administers a duty drawback system to refund exporters duties that have been on imported inputs in order to reduce the anti-export bias which arises from the tariff regime.¹⁰⁰ Drawback rates are set by FBR using input output coefficients. CBR also offers the Duty & Tax Remission on Export (DTRE) scheme, designed for regular exporters, whereby an exporter is entitled to duty- and GST-free purchases of inputs from the local market or abroad through “suspension,” rather than rebate. The program is open to both direct and indirect exporters and in doing so, mitigates the anti-export bias present in the tariff structure.

181. While the systems are said to have a positive impact on exports¹⁰¹ the efficacy of the duty drawback system is increasingly in doubt due to its implementation in Pakistan. Firms encounter substantial delays ranging between three to six months as well as high levels of administrative costs that prevent the anti-export bias from being fully eliminated. There are reports of misuse of the scheme by businesses through export houses, erroneous documentation and product substitutes.¹⁰² In general, duty suspension schemes are more favorable than drawbacks but require adequate administrative capacity and auditing procedures to be successful.¹⁰³

⁹⁸ For example, new and used concrete-mixer Lorries eligible for the 5percent concessionary rate are limited to an all-up quota of 2,500 units, allocated on a "first come first served" basis.

⁹⁹ 1934 eight-digit HS codes (over 600 in mid 2000) including 1,000 tariff items of raw materials not made in Pakistan can be imported from India for use in exports contravening WTO rules. At that time, informal trade at a transaction premium above the formal channels (informal/smuggled trade between the two countries, either directly, through Afghanistan), or re-routed through third country ports, mainly Dubai and Singapore, is estimated at between US\$ 250 million to US\$2 billion annually (ECU 1999, Taneja 2004).

¹⁰⁰ Under the WTO, duty drawback and/or suspension are not necessarily considered export subsidies unless refunds or exemptions are higher than the duties that were actually paid on the imported merchandise that is subsequently exported, or if the government exempts the producer from paying duties on inputs that are not used in the manufacture of exported goods.

¹⁰¹ Research suggests a short-run positive impact of duty drawback rates on exports. Ul-Haq, 2007.

¹⁰² Nadeem (2009) concluded that prevailing duty drawback rates (DDRs) were in fact higher than the actual incidence of custom duty on those items.

¹⁰³ Recent investigation by the Auditor General (AG) of the GoP has focused on the misuse of the DTRE scheme by steel importers. The AG office has suggested that the FBR should develop a strong internal control mechanism, and exert close monitoring on proper feeding of import/export data in Pakistan Customs Computerized System (PaCCS) to ensure remittance of foreign exchange and export of DTRE goods

182. ***GST Rebates on Inputs.*** The draft Sales Tax Bill currently under consideration was meant to replace the 1990 Sales Tax Act. In addition to unifying sales tax rates to 15 percent, the new bill eliminates discrimination between imported and domestic goods. As well, zero rating of selected sectors needs to be confronted. The sum is that sales taxes collected on import transactions shows a high variation in effective sales and federal excise tax, and within manufacturing, for example, reinforcing incentives in favor of textile relative to other manufacturing. Eliminating exemptions and zero rating would widen the base, generate revenue and help reduce the anti-export bias. The effective rate of excise duties applied on import transactions in 2009/2010 shows differentiation across sectors with substantial variation in rates (Table 20). As excise duties are small relative to other taxes, they do not alter the apparent anti-export bias discussed above.¹⁰⁴

Table 20. Applied Sales and Federal excise tax on Imports, 2009/10

	HS-Codes	Sales Tax		Excise Tax	
		Mean	Coef.Var	Mean	Coef.Var
Live Animals and Animal Products	01 to 05	2.6	2.3	0.3	1.3
Vegetable Products	06 to 14	6.9	1.2	0.3	1.3
Fats and Oils	15	1.9	3.0	9.3	0.8
Prepared Foodstuffs	16-24	9.3	1.0	0.7	6.5
Mineral Products	25-27	9.4	0.9	1.8	3.4
Chemical	28-38	6.3	2.5	2.0	66.0
Rubber and Plastics	39-40	9.3	1.3	0.5	0.9
Raw Hides and Skins	41-46	8.0	1.0	0.6	53.4
Wood Pulp	47-49	8.5	1.1	0.3	1.4
Textiles	50-63	3.1	2.0	0.3	1.9
Footwear,	64-67	3.3	2.0	0.3	1.4
Stone, Plaster, Cement	68-70	10.1	0.8	0.5	0.8
Pearls, Precious Or Semi-Precious	71	10.3	0.7	0.6	0.8
Base Metals	72-83	10.0	1.2	0.5	1.0
Machinery and Appliances	84-85	7.9	1.0	0.6	0.7
Vehicles, Aircraft, Vessels	86-89	13.4	0.5	0.7	0.5
Optical, Photographic, Measuring	90-92	6.2	1.3	0.7	0.6
Arms And Ammunition	93	1.9	2.9	0.1	2.9
Miscellaneous Manufactures	94-95	10.7	0.7	0.6	2.1
Works Of Art	97-98	14.1	0.4	0.8	0.4

183. ***Export Processing Zones.*** There are five Export Processing Zones (EPZs)¹⁰⁵ presently in operation in Gwadar, Karachi, Risalpur, Saindak, and Sialkot with several others planned. Karachi and Saindak account for the majority of EPZ production and exports, equivalent to some 97 percent of EPZ exports between July 2010 and May 2011. While EPZ enterprises pay the same presumptive tax as other exporters—one percent of export value—EPZ enterprises were in the past permitted to sell up to 20 percent of their output to the domestic market. This has changed and any sale to the domestic market is subject to approval. As exports from EPZs are concentrated in textiles and

¹⁰⁴ Full exemptions on excise duty are affected on a relatively limited number of transactions, mostly within one product group, palm oil. The 2008 WTO TPR reported that excise tax concessions favor local content in a number of products including aerated waters made wholly from indigenous juices of fruits, vegetables, and food grains that contain no other local or imported are taxed at 10 percent of the retail price instead of 12 percent. In addition crude vegetable oil (excluding cooking oil) obtained from locally grown seeds is exempt from the 15 percent excise tax.

¹⁰⁵ EPZ enterprises are permitted duty-free import of machinery, equipment and materials used in export production.

apparel¹⁰⁶ the concessions have provided little in the way of development goals such as export diversification or progress of the less developed regions.

184. ***Manufacturing under Bond Scheme.*** CBR operates a bond scheme for manufacturing which allows on-site bonded warehousing of imported inputs. Bonded manufacturers may sell up to 40 percent of their output in the domestic customs territory subject to the payment of applicable duties and taxes. The manufacturing under bond scheme does not provide duty free imports and allows manufacturers to locate anywhere in the country, subject to licensing.¹⁰⁷

185. ***Income Tax Concessions.*** Sector-based tax concessions have been phased out though income from agriculture production remains exempt from income taxation. Exports are also not subject to regular corporate income tax (currently 35 percent of net taxable income) and are subject instead to a presumptive tax of one percent of export value. In addition, some imports, which are subject to a general 5 percent withholding tax, are levied at concessionary rates. The substantial difference in tax rates (company tax rate of 35 percent) suggests possible sizeable subsidies for more profitable exporters, while low- or non-profitable exporters are still subject to taxation. More importantly, as firms are taxed on the value of exports, rather than value-added with no credits or deductions for investment, the export tax system provides a disincentive to investment in new capital or technologies. As it turns out, most exporters are actually penalized and not assisted by the income withholding tax arrangements.¹⁰⁸

186. ***Export Finance:*** The State Bank of Pakistan (SBP) provides short and long-term financing to exporters on concessionary terms. The short-term Export Finance Scheme (EFC) provides working capital through banks for up to 180 days, on a transaction basis, for both direct and indirect exporters, or a performance basis, whereby an direct exporter qualifies for a revolving credit. The Long-term Financing for Export Oriented Projects (LTF-EOP) scheme allows eligible financial institutions to provide funding facilities to export-oriented enterprises for the import of machinery, plant, equipment and accessories not manufactured locally.

H. Export Subsidies: An Assessment of Incentive Bias

187. ***Exports are accorded a high priority in the Government's assistance strategy and has received assistance in many forms;*** both through general and sector schemes offering income and other tax exemptions/concessions, direct subsidies, such as for freight and research and development grants and concessionary credit.¹⁰⁹ The limited analysis which exists examines two concessionary finance measures on export performance concluded that the export financing scheme had a negative

¹⁰⁶ Export Processing Zones Authority, "Progress Report, July 2010 to May 2011".

¹⁰⁷ Notwithstanding the above schemes, the Strategic Trade Policy Framework, 2009-12 indicates that exporters are, on average, forced to export indirect taxes, until the drawback mechanisms can eliminate such anomalies.

¹⁰⁸ While an ex post cost-benefit analysis is required to fully assess the impact of the export subsidy scheme, the nature of the regime adds to an already highly distorted incentive regime.

¹⁰⁹ The genesis of export related policies can be traced to measures such as Export Bonus schemes (1959) allowing the import of certain items, not generally importable, up to 10 to 40 percent of the value of export, income tax rebate (1972) up to 25 percent of income, EFS (1973) with subsidized interests rates, financing for locally manufactured machinery, LMM, (1972), Cash Compensatory Rebate (1978) for exports up to 12.5 percent of value and R&D support (2005) ranging from 3 to 6 percent of value added.

impact while the rebate/refund scheme was insignificant.¹¹⁰ Despite these efforts, policies of subsidizing exports have continued irrespective of their effectiveness in generating declared outcomes or opportunity costs of scarce government resources.¹¹¹

188. *Current industrial structure is largely a consequence of government's historical patronage* aimed at achieving rapid industrialization with export sector receiving high priority. The textile and clothing sector by design become pivotal in government support. Public intervention in Textiles and Clothing (T&C) spans four decades, characterized by one of three methods—"direct control, managed domestic prices, and free markets targeting the cotton sector."¹¹² In addition, Pakistan's Research and Development (R&D) incentive equals 3-6 percent of the free-on-board value of added value textiles and garments for export. The 2009 Textile and Clothing: Textile Policy continued these various general and sectoral schemes intend to help meet greater competition in developed markets in the post MFA era with initiatives for exporters including:

- *Drawback of Local Taxes* where provincial levies and local taxes collected from processed fabrics, home textiles and garments are refunded to exporters at the rate of one, two and three percent of their FOB value, respectively.
- *Technology Up-Gradation Support Order* for projects exceeding investment of Rs 10 million or more in machinery or technology, government supporting 50 percent of mark-up subject and smaller investment receiving 20 percent.
- *Mark-up Support for Textile* providing grants for new plants providing 2.5 percent support in mark-up against outstanding loans availed by exporters from commercial banks under Export Finance Scheme (EFS) in mark-up against outstanding loans.

I. Compensatory Support to PTA Users

189. In contrast, for the non textile and clothing sector specific schemes can be summarized (i) freight subsidy of 25 percent on air shipments of live seafood, (ii) an R&D subsidy of 6 percent exports proceeds of processed foods, (iii) schemes compensating employees of exporters providing allopathic medicines at US \$500 - \$1000 per month for a period of two years, and (iv) 50 percent subsidy cost registering pharmaceutical products in foreign countries.

190. Two financing schemes supported exports; the Export Finance Scheme 1973 (EFS) and the Long Term Finance Facility 2008 (LTTF) which provided credit below market rates for export oriented units for financing exports and purchasing of new machinery, respectively. Funding under for EFS was available to direct and indirect exporters and trading companies apart for exports in raw cotton, rice, wools, hides, and wet blue leather.¹¹³ Under EFS, concessional rates were available for units having annual export greater than US \$5 million or at 50 percent of sales (whichever are lower).

¹¹⁰ The export financing (EFS) and rebate/refund schemes were analyzed by Nadeem Ul Haq and Ali Kemal (2007). Seminal work by M.H. Khan and M. Ishfaq (2009) suggested that credit under EFS is weakly correlated with overall exports and Zia (2006) who indicated that EFS can be termed partially effective at best.

¹¹¹ Under the WTO, export subsidies are defined as: financial contribution by a government or any public body within the territory of a member; a government practice involving a direct transfer of funds, potential direct transfers of funds or liabilities; government provides goods or services other than general infrastructure, or purchase goods; government revenue that is otherwise due is forgone or not collected and any form of income or price support.

¹¹² Townsend and Gutichounts, 1994.

¹¹³ See the list of CGO 11/2007: <http://www.fbr.gov.pk/Docs/2010113141132597032007CGO11.pdf>

In 2006-07 exporting firms were allowed to swap loans obtained from financial institutions on normal rate of interest with loans under the LTFF.

191. *The export incentive regime not only systemically bias resource allocation* against the non-textile industry in general, and specifically against new entrants but also between stages of the textile and clothing supply chain. Partly a historical precedent, concessionary measures on cotton yarn was included in almost every subsidy regime at the outset of the industrialization strategy. At the same time, the cotton price support and trade policy measures system ensured a subsistence level of industry and discouraging farmers from investing farming methods to upgrade yield and quality. Neither yarn spinners nor textile mills utilized this cost advantage of low cotton prices to invest in cost-savings or upgraded technology.¹¹⁴ Furthermore, there are different rates of drawbacks of local taxes favoring higher value added products at the expense not only of the cotton growers, but also the productivity of ginners and yarn producers. Recent episodes of quota and regulatory duty on yarn along with the structure of the export incentives and disbursement patterns of EFS and LTFF demonstrate that the policy bias toward established and higher value segments of exports continues.

192. There have been a number of adverse consequences from credit subsidy measures. First, large scale exporters have engaged in over-invoicing to benefit from credit subsidy.¹¹⁵ Further, evidence points to subsidies being ‘monopolized’ by influential exporters,¹¹⁶ implying that the credit subsidy has secured profits of established firms and discouraged productivity and technology improvements that would have otherwise occurred. Finally, the incumbent’s benefits effectively raises the barrier to entry by favoring present exporters and stifles resources from productive enterprises, as resources are drawn to those sectors with the most favorable incentives.

193. In spite of, or perhaps because of, government efforts in the textile and clothing sector, export unit values have remained low (Figure 41). While market shares for the principal export items were either gaining or maintaining world market shares the past few years, unit values have remained relatively low. For Pakistan’s top eight exports, accounting for 70 percent of its textile and clothing export, the unit values achieved were the lowest amongst its main competitors, with some marginal gains from 2002 to 2010.¹¹⁷

¹¹⁴ Hudson and Ethridge, 2007 Ud Din and Ghani, 2004, and www.astm.org/SNEWS/JA_2009/perspective_ja09.html.

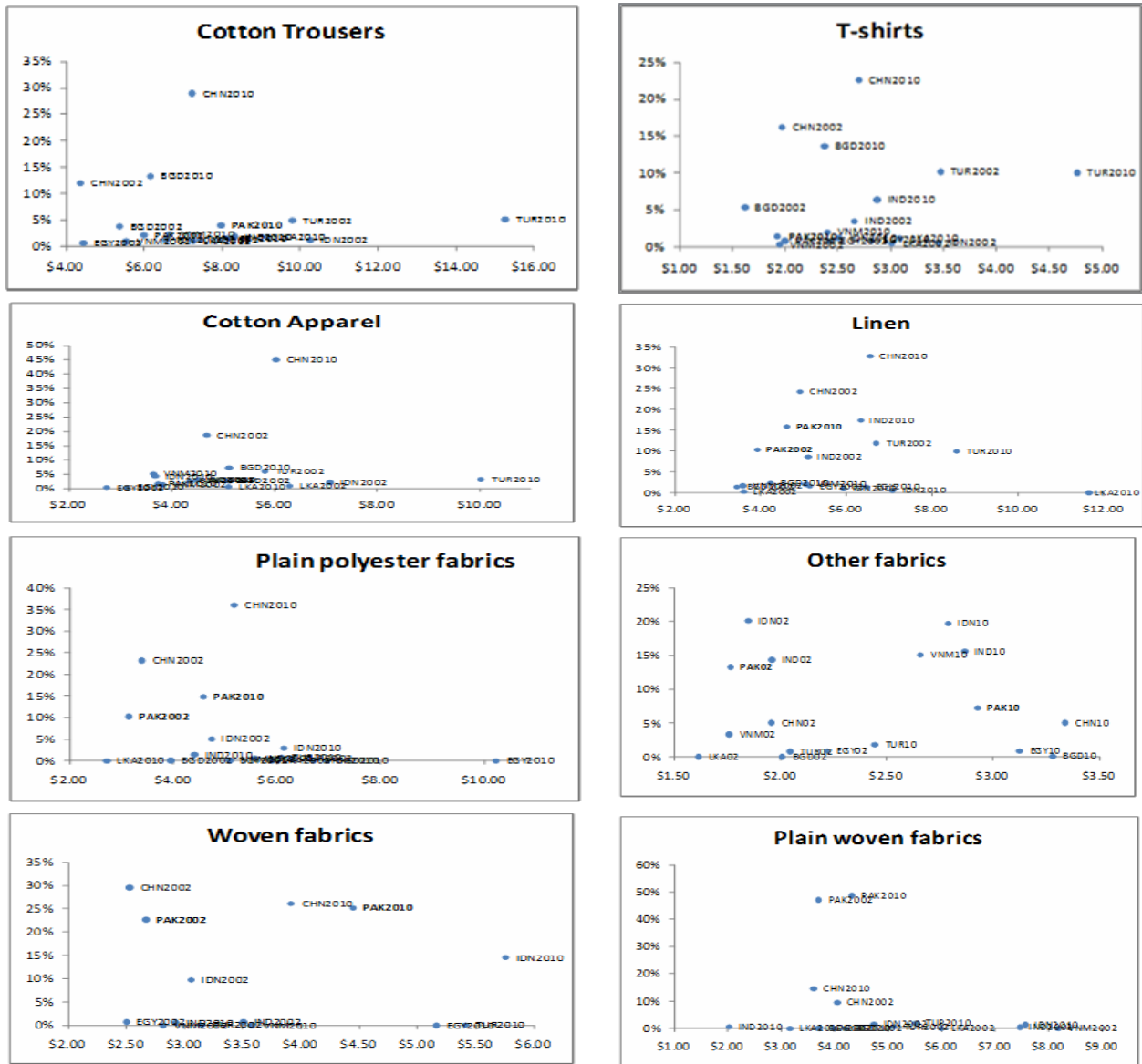
¹¹⁵ Khan and M. Ishfaq (2009). Mahmood and Azhar (2001) provided evidence of a significant difference between the duty-drawback rate and the premium on foreign exchange in the kerb market.

¹¹⁶ The top 100 exporters account for 61 percent of outstanding loans under EFS and the top 18 exporters have 28 percent of outstanding loans under EFS. Khan M. H. and M. Ishfaq (2009). Evidence of connected lending in Pakistan argues that political connections of firms help in reducing their borrowing cost. Khwaja and Main (2005) However, evidence also showed that credit subsidies were inefficiently captured by publically firms. Zia (2006).

¹¹⁷ Pakistan’s main export destination, the USA, the price of Square Meter Equivalent (SME) of Pakistani T&C products US\$1.10, is much lower than the average price of US\$1.69 (or 34%) of SME of T&C products imported from worldwide sources.

Figure 41. Comparative Price Levels for Selected Products

year



194. Export subsidies, pursued in the name of providing temporary assistance to encourage technological and other improvements to enhance competitiveness, have not helped Pakistan diversify or improve the quality of exports—as would be suggested by country and firm level evidence on the subject.¹¹⁸ Instead, it has been received by established industries and companies within those industries, and in doing so reinforced market power against new entrants. The

¹¹⁸Helmers Trofimenko (2010), Tybout (1999) and (Hoffmeister (1991) and empirical evidence Pakistan (Ul-Haq, 2007), Ishfaq (2009) does not refute these assertion. It has been shown that under undistorted market conditions most productive firms will engage in trade directly, less productive will do so indirectly, with the least productive firms serving the domestic market (Holtzner and Larch (2011)). The “success” stories are often based on cases in which traders would have carried out the activity un-assisted by government (Panagariya, 1999).

incumbents' successful campaign to sustain government assistance has served to maintain margins at or above normal profits, but has done little to raise unit values and value-added production. The abnormal profits, however, have drawn investments towards it and perpetuating the sector beyond what the market would otherwise bear, and created excess capacity.

195. Given the difficulty in tying assistance to increased efficiency or cost reductions, as envisaged in the EFTs and LTFF, a neutral, incentive regime which is phased out over time but which does not discriminate among sectors, firm size, or performance may be preferred.¹¹⁹ The appropriate instrument for realizing the positive externality from the expansion of domestic industry may not be a tariff or a subsidy, but rather a mechanism that relates a fiscal incentive to knowledge or learning as a public good with the following characteristics:

- Linked with capital investment
- Non-discriminatory, available to both exporting and non-exporting enterprises
- Aimed at meeting clear targets
- Has a clear monitoring and evaluation framework to ensure funds are used as intended
- Time-bound.

J. Institutional Framework for Trade Policy-Making: Lack of Coherence

196. *The current framework for trade policy is fragmented and captured by special interests.* The National Trade Policy Framework and recent National Industrial Policy recommendations recognize the need for a trade policy that promotes greater value-added and export competitiveness of Pakistan's industries. In practice however, the process and ultimate policy lacks the necessary cohesiveness to balance competing demands of various interests groups while maintaining focus on the overall policy objectives. In part, the outcome is the result of a lack of clear institutional or strategic framework for the development of trade policy.¹²⁰ This lack of policy direction is apparent in the outcome of the yearly National Trade Policy, which reflects the competing range of agendas.

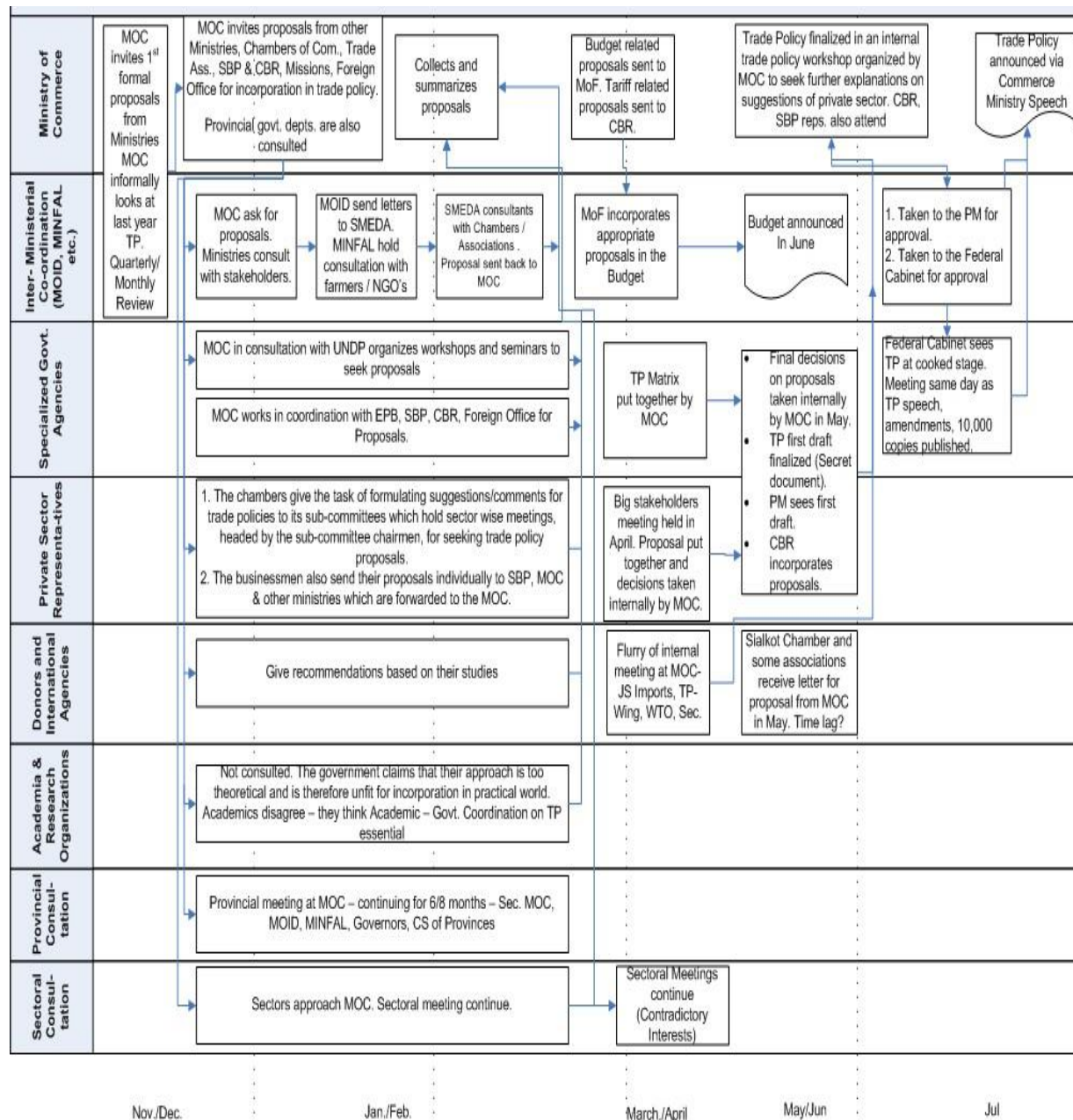
197. Tariff setting, for example, is undertaken through the annual Budget announcement after the CBR determines annual tariff rates in close collaboration with key ministries, mainly Finance, Commerce, and Industry. The implementation of the process is entrusted to the Ministry of Commerce (MOC) through an Annual Trade Policy (ATP). The sub-agency, National Tariff Commission (NTC), "administers trade defense laws with regard to Pakistan's international treaty". NTC also assumes an extended mandate "to function as a think tank for the government on matters relating to competitiveness of the industry". This includes extra protection, anti-dumping and countervailing measure that may occur beyond the budget proceedings. Changes proposed beyond the purview of the budget are submitted to NTC which then reviews and changes are issued by FBR by way of an SRO, which is approved by the Economic Coordination Committee of Cabinet.

¹¹⁹ For example, investment credits, allowances, accelerated depreciation, and other similar measures that can be provided through the Tax Code (Tanzi and Zee, 2001).

¹²⁰ The GoP's Rules of Business do not specifically assign Trade Policy to any ministry. In fact, trade policy as such is not mentioned at all.

198. The process depicted below provides an overview of the ATP consultation process, which engages various government entities and private sector stakeholders (Figure 42). Its complexity notwithstanding, notable absences are academia/research organizations, consumer groups, and many service sectors that are ultimately impacted by trade policy. While there is not a clear explanation the ATP to be an annual feature, the structure of the process provides the business community a good opportunity to provide individually tailored measures—particularly after it follows just a couple of months after the Finance Bill and can be viewed as a second opportunity to acquire government support.

Figure 42. Trade Policy Formulation in Pakistan



199. In practice, however, the process allows trade policy formulation to be deferred to multiple actors that directly influence trade policy on behalf of the sectors and/or firms they represent, detracting from attempts at trade policy coherence. For example, trade policy related to textiles has been handed over to Ministry of Textiles since 2007 which has designed the subsidy programs for the sector, and pursues a policy of “cascading” tariffs.¹²¹ This policy is evident in the nominal tariffs structure where raw cotton carries low and zero tariffs and finished garments 25 percent. The latest draft Industrial Policy considers trade policy through a “two-tier export tariff regime” with regard to domestic raw material exports to secure needs of downstream export-oriented industry.¹²² Provincial Governments, too, weigh in (for instance when the Sindh Government chose to levy a ‘cess’ on imports that amounted to para-tariffs).

200. Tariff policy for the vast range of engineering goods has been entrusted to the Engineering Development Board (EDB)—responsible for the development of the local engineering industry. The EDB’s role on trade policy emerges an explicit policy stance of the Ministry of Industries. The EDB decides the policies from raw material procurement to tariffs of engineering goods. With advice from specialized industry-specific committees that have firms and trade associations as members, the EDB routinely intervenes to secure concessions on inputs directly through FBR, bypassing the NTC effectively asserting the EDB’s role in the tariff setting agenda for the industrial sector.¹²³ While the motive is indigenization—with the aim of augmenting the ‘local content’—it also actively propagates protection of selected industries, principally consumer durables such as auto industry, motorcycles, air conditioners and various types of industrial machinery and equipment through bans and restrictions on imports of second-hand products.

201. Other areas of trade policy have been heavily influenced by sectoral interests. While a consultative process is an important pillar of any trade policymaking framework, the current structure in Pakistan allows sectoral interests to take decisions without reference to the broader community of stakeholders, such as consumers and upstream or downstream sectors. Trade policy formulation has, in practice, become a series of subsidies and other protective measures in the name of “export promotion”. The Ministry of Textiles and representative private sector associations are heavily engaged in driving forward this agenda. Moreover, the specialized ministries often formulate policies without taking into consideration the impact on either other economic sectors (upstream and downstream industries and service sectors) nor consumers—the general equilibrium aspects are not fully understood or appreciated. This is perpetuated by the absence of adequate analysis of trade policy reform proposals and/or their impacts on different economic sectors and/or consumers.

¹²¹ The Textiles Policy 2009-2014 publication under the heading “Tariff Rationalisation” (para 7.1d 6) formally engrains this policy by stating, “The principle of cascading will be implemented while ensuring adequate protection to the local industry and removing anomalies”.

¹²² The draft calls for raw material exports within the quota at zero rates (in quota) export tax, while exports in excess of the quota are charged at a higher (out of quota) export tax. Recent evidence of yarn and cotton export restrictions in 2009 and 2011 is symptomatic of this policy, giving credence to powerful lobby groups such as All Pakistan Textile Mills Association (APTIMA) and Pakistan Tanners Association (PTA).

¹²³ The latest National Industrial Policy “Implementation Framework” states, for example, that “policies for industrialization cannot be pursued in isolation from trade policies and that the tariff policy and related decisions are in conformity with the industrialization strategy of the country. The decisions on tariff restructuring of items relevant to industry should also be taken by the Board Industrial Policy Implementation Framework of the Ministry of Industries, pp. 27, <http://www.moip.gov.pk/>.

Box 6. Experience in Trade Reform

While the countries of East Asia employed varying trade policy frameworks, a common outcome is that they substantially increased exports and are now active participants in the global trading environment.

In South Korea and Taiwan, export incentives coexisted with protection of the domestic market. Success required offsetting the bias against exports from the inherent high domestic protection. South Korea in particular, used duty-drawback, indirect duty-drawback, and temporary admission to offset duties on imports. While duty drawbacks were useful for Korea, their effective operation requires high levels of administrative abilities, preventing many developing countries, including Pakistan, from taking full advantage of the system, in the way Korea did. Partly as a result, empirical evidence finds that drawback regimes are more likely to be welfare improving if the administrative cost of collection is low (Ianchovichina, 2005 pp 12).

China and Mauritius adopted a two-track policy of development: *import substitution* based on temporary protection against imports, combined with an *export* orientation to open up to the world economy. Both actively promoted special economic zones for export development so that zones would allow duty free imported intermediates. There has been mixed results. China's success stands in stark contrast to other regions. Privately-operated special economic zones that allow for export and domestic production have fared better. Zones are also a demonstration project from a more liberalized trade and investment regime.

Chile, Hong Kong and Singapore are examples of economies that shed protectionist policies and non-tariff barriers. Hong Kong and Singapore, both small markets, established free-trade regimes, linking their domestic prices to international prices, with neutral incentives between producing for the domestic or international market. Both economies made export credit available, although they did not subsidize them. Chile took an intermediate path, adopting a uniform tariff that was gradually reduced over time. Hong Kong and Singapore have since "graduated" from manufacturing, moving their economies toward the provision of value-added services and research and development.

Under uniform tariffs, exporters have equivalent incentives to those who produce for the home market, eliminating the anti-export bias and the need to manage a complicated regulatory regime. Chile, El Salvador, and the Kyrgyz Republic have successfully introduced tariff structures with very small dispersion, and Hong Kong, Estonia and Singapore have a uniform tariff of zero. Other countries, after pursuing two-track approaches—including Indonesia and Malaysia, and, later, Mauritius and Turkey — moved from high and dispersed tariff regimes to more unified rates. Export performances were greater following periods which gave their exporters equivalent incentives to those that produced for the home markets. What made such system work is an efficient bureaucracy, insulated from political pressure, sufficient to withstand rent-seeking and associated corruption. Experience suggests that most developing countries lack the kind of deep, efficient, non-corrupt bureaucracies that allow them to manage a complicated regulatory regime especially administering either a differentiated tariff system, duty drawback or efficient export subsidy system. The South Korean model has not been successfully replicated elsewhere. Such strategy in fact had disastrous consequences in those that followed (Weiss, 2002).

The lessons above reflect many of the highlighted principles relevant for Pakistan: high and cascading tariffs raise domestic prices relative to export prices, and thereby provide incentives for businessmen or entrepreneurs to produce for the home market and to ignore exports. Exports are taxed through two channels: first, resource allocation channel and the other, protection cause an appreciation of the real exchange rate thereby making exports less attractive. Simple, transparent protection regimes with low uniform tariffs are the most effective way of stimulating trade and opening up an economy to the international market - through the use of a liberal trade regime, rather than through a complex structure of protection and export incentives.

The lessons are that reforming trade, by reducing tariffs and trade distortions, is a prerequisite, but insufficient means of fully exploiting trade growth. Complementary policies, structures, and institutions aid trade and export growth, including measures to streamline behind-the-border institutions and policies, such as port efficiency and customs administration, as well as quality of infrastructure and regulatory environment. The World Bank's Trade Strategy noted that "firm competitiveness and productivity such as access to efficiently-produced backbone services—countries where firms have to pay more than their competitors for energy, finance, telecommunications, customs services, transport, logistics, and business registration and operations, will find it increasingly hard to compete on global markets".

CHAPTER IV: DOMESTIC FACTORS AFFECTING EXPORTS

A. The Overarching Challenges: Shocks, Stability and Scarcity

202. While many aspects of the country's current challenge are indeed within the hands of policymakers, as describe below, many are not. Certainly, Pakistan's perfect storm which continues to characterize the country's fortunes, have roots in both types of events—exogenous to policy and endogenous. In this final section, the exogenous factors are noted, followed by three current challenges to the goal of industrial and agricultural diversification—macroeconomic stability, power and water.

1. *The Plague of Recurrent External Shocks*

203. A number of recent shocks have devastated various parts of Pakistani society at various times—the reverberations of which are still being felt in the country and will be for some time. These forces have been outside the control of the country's policymakers.

- The transfer of power from the military to the civilian leadership coincided with a large increase in the price of oil and also that of a number of other commodities—such a wheat and edible oil—that were important components in the import basket.
- A devastating earthquake in 2005 in several northeastern districts took 85,000 lives and destroyed thousands of houses, hundreds of schools and clinics, scores of bridges and hundreds of kilometers of roads. While the military-led government did a credible job of dealing with the crisis, much remained to be done when the transfer of power took place.
- Two years into its tenure, a “hundred year” flood took a heavy economic toll. While there were relatively few deaths, about one eighth of the population was displaced and lost the sources of their livelihood. The asset destruction was estimated at more than 6 percent of GDP.

204. The estimates of the direct and indirect cost of terrorism borne by Pakistan paints a grim picture of the situation. During the four years between 2005 and 2008, 4,818 terrorist acts were committed and over 11,000 people killed. These attacks have had both direct and indirect economic costs, estimated at a total loss of US\$31.3 billion in the five year period between 2004 and 2009 that could be attributable to terrorism. GDP would have increased by between 1.25 to 1.5 percent a year in this period. The cost has risen steadily; it has increased from 4 percent of GDP in 2004-05 to 5.1 percent in 2008-09.

205. Pakistan's relations with the outside world have always been dictated by its fear of India. While India's preoccupation with Pakistan declined, once its economy began to grow and came to be recognized as an emerging power, that was not the case in Pakistan. The India-centric approach took Pakistan in many directions, including seeking alliances with distant partners, including the US which has been deteriorating recently as relationships with India has been warming.

2. *Macroeconomic Management*

206. The recent period of 2008-2012 started with the country in crisis. The economy was under stress due to the Government's loosening of the purse strings. After a period of strong economic expansion, relative macroeconomic stability, and increased foreign investor confidence over the years 2003-2006, the country in 2008 faced a very different and serious set of strains and challenges.

The fiscal deficit had grown eightfold over the 2004-2008 period to reach 7.5 percent of GDP while the current account deficit shot up to US\$14 billion in 2007-08 or 8.4 percent of GDP—financed not be foreign investment by a run down in foreign exchange reserves which fell from US\$15.4 billion in November 2007 to US\$6.5 billion a year later—less than two months of foreign exchange payments. Pakistan sought assistance from the IMF to avoid the major disruption in economic activity that would come from balance of payments crises.

207. The new government inherited a difficult economic situation. Recognizing the need for fiscal reduction, it started the painful process of energy price adjustments, the scaling back of public development expenditures and strengthening incentives for agriculture by boldly increasing the wheat support price. However, the situation continued to deteriorate and became grim in 2010. The economy stood at the edge of an abyss. Rather than respond by continuing to foster the deep structural change the economy needed, the government chose to rely on large IMF flows to ride out the crisis.

208. Islamabad was not able to put in place the needed but long-postponed economic reforms. It dragged its feet on improving the fiscal situation by reforming the tax code—by increasing the tax base, bringing into the tax regime the sectors (such as agriculture) that had stayed out mostly for political reasons, and by levying some form of value added tax. Lack of progress in this area resulted in the suspension of the nearly US\$4 billion of undisbursed amount from the IMF and later the decision by Islamabad in late 2011 to walk out of the program altogether, leaving the country facing a external account pressures which will become serious when the repayments to the Fund begin.

209. It is unlikely that the country will see its national product growing at much more than the 2.4 percent increase in 2011. The most palpable result is that the rate of job growth will slow and the incidence of poverty will increase. While there are no firm numbers available, probably a third of the population—or 60 million people—live in abject poverty. To keep this number from increasing, Pakistan will need a growth rate twice as high as the rate of increase in population and three to four times as high to reduce it significantly. In other words, the country should be aiming at a rate of GDP increase of 6 to 8 percent a year.

210. To tackle the problem posed by the absence of adequate amounts of domestic resources, Pakistan needs to increase its tax to GDP ratio which, at 8.6 percent, is among the lowest in the world. To increase this ratio requires a tax system that is broad-based and free of loopholes, an effective tax collection agency, and willingness on the part of the well-to-do to pay their share into the coffers of the government. The share of sub-national governments in total resource mobilization by the state is only 5 percent for taxes and 8 percent for tax and non-tax revenues.

3. *Scarcity of Water*

211. Pakistan is one of the world's most arid countries with annual rainfall of less than 240 mm. At the same time agriculture is an important part of the economy, accounting in 2010 for over one-fifth of the GDP. Since the time of the British who invested heavily in tapping the Indus River system for irrigating the virgin lands of the Punjab and Sindh, irrigated agriculture has become an important part of the sector. Over 80 percent of the cropland is irrigated. Most of Pakistan's important crops—wheat, rice, cotton and sugar cane—rely on surface irrigation. As discussed below some of these would not be part of the farming pattern if water was properly priced. The country receives an inflow of 104 million acre feet (MAF) of water from the Indus basin of which 64 MAF is used for agriculture, while the rest is lost to the Arabian Sea.

212. The construction of a dam on the Indus at a Kalabagh in Khyber-Pakhtunkawa has met with great resistance from two provinces. Most experts regard the dam as an important part of the system that would maximize the use of water available in the rivers. The opposition comes from both Khyber-Pakhtunkawa province that would not like to lose the land that would come under water and Sindh that fears the further loss of the water in the Indus River to Punjab, the province that would benefit the most were this dam to be constructed. Pakistan currently lags behind other countries with major river systems in terms of water storage capacity.

213. Inefficient use of water that flows into the vast irrigation system that has been developed over time presents another problem the country must deal with in order to lay the ground for the economy's rapid growth. From the annual flow of 141 MAF into the Indus system, about 106 MAF is diverted of which 96 percent is used for agriculture while 4 percent is consumed by industry and households. However, a significant part of the water that flows into the irrigation system is wasted – perhaps as much as 50 percent—because of antiquated design, poor maintenance, poorly leveled fields, and evaporation/seepage into the ground. The water that seeps into the ground is recovered by half a million tube wells that have been installed over the last 50 years.¹²⁴ Ground water pumping has increased from 3.34 MAF in 1959 to 55 MAF in 2009. Tapping of this resource is done without regulation. The result is that there is “mining” of water with the amount extracted exceeding the amount of natural discharge. About 70 percent of the working tube wells are now producing hard or brackish water which is exacerbating the salinity problem.

214. Climate change is also affecting Pakistan's water situation as glacier retreat is likely to have serious consequences for the availability of water as Pakistani rivers receive most of their water from melting ice. It is anticipated that Pakistan will be a serious “water constrained country” by 2025. The problems can be resolved by the adoption of appropriate public policies focused on the following areas:

- A greater fiscal mobilization effort described above to maintain an antiquated irrigation system while increasing the storage capacity, including the construction of such large dams as the one at Kalabagh. Insufficient public sector investment in maintaining and developing water courses is an important contributor to water scarcity in the country.
- Water pricing such that the price for water appropriately reflects the present and future scarcity value of this commodity. Farmers will have an incentive to level their fields to minimize the waste of water and will move away from cultivating such water-intensive crops as sugar cane.
- A regulatory system that would watch over the use of water. For instance, the use of ground water for irrigation, manufacturing and domestic use is hardly regulated. The result is mining of water which is causing a sharp drop of the water table in many areas. To prevent the further deterioration of the situation, Pakistan's policymakers need to install the right price regime which is properly supported by a regulatory system.

¹²⁴ Tubewells developed as an important source of water by farmers without support and knowledge of the government, as noted by Ghulam Muhammad, the Pakistan Institute of Development Economics in the mid 1960s.

4. *Scarcity of Power*

215. Electric power shortages averaged 4 to 5 hours per day and are contributing to significant economic stress. While distribution companies attempt to ration power supply based on the needs of the end users, most large firms still invest in self generation despite the high costs - estimated at two and a half times the cost of power obtained from the distribution companies. Other firms change hours of operation if they can. However, recovery rates are highest in industries which have acquired self-generation capabilities (at 85 percent), while other units lose about 73 percent of the output.”¹²⁵ One estimate is that load shedding was costing an equivalent of two percent of GDP.¹²⁶

216. The share of domestic demand in the last decade doubled from 23 percent of the total in 1980-81 to 46 percent in 2007-08. However, no significant new investments were made to generate additional power and mitigate the widening supply-demand gap.¹²⁷ In the 1990s, Islamabad turned to the private sector—the Independent Power Producers, or IPPs—to invest in the energy sector to increase supply. The IPPs were offered rich returns by way of guaranteeing the price at which their output would be bought by the Water and Power and Development Authority (WAPDA).

217. However, the pricing policy for the purchase of output by the IPPs was not balanced by appropriate adjustments in tariffs for the consumers. This left a number of generating companies operators with unpaid bills by the distribution companies owned by WAPDA. The IPPs, in turn held back payments to the companies that supplied fuel; the fuel suppliers curtailed their sale to the generating companies who then cut down on the amount of power produced. This problem came to be called the “circular debt problem”. On a number of occasions the government stepped in to write off the debt. Each time this was done, electricity generation increased, reducing the gap between supply and demand.

B. Economic Governance, Labor Policy and Access to Finance

218. The investment climate assessment provides the analytical framework for observing, first hand, at the firm level, constraints to the type of dynamics and flexibility which is needed for export diversification. Surveys and market information triangulate specific areas from three directions: (i) firm managers rankings regarding the severity of specific obstacles, (ii) empirically tested hypotheses relating investment climate variables to firm performance to uncover statistically significant relationships, and (iii) investment climate benchmarks compared across countries, against itself over time, and across provinces, sizes and industries.

219. The analysis reveals significant improvements in “first generation” reforms during the first part of the 2000s, such that those obstacles, which were significant at the beginning of the decade are now viewed as secondary. The reported improvements in the business climate during the first half of the decade was based on lower concerns for the hassles associated with tax administration, labor regulations as well as customs and trade regulation and strong network benefits stemming from privatizing telecommunications and financial services. Infrastructure (other than power), skilled labor, and business regulation were also not considered as constraints to business, but in these cases it is

¹²⁵ Institute of Public Policy, *State of the Economy: Emerging from the crises*, Lahore, 2009, p. 69.

¹²⁶ Ibid, p. 70.

¹²⁷ The share of public sector expenditure on the power sector which averaged about 28 percent of the total in the two decades before the Musharraf period declined to less than 3 percent while he was in office.

more due to the low level equilibrium firms find themselves in, which prevents the sector from advancing and viewing the areas as constraints.

220. On the other hand, the removal of binding constraints from first generation reforms may have also raise more fundamental issues, such as electricity, water, corruption along with considerable concern for the macroeconomic and political uncertainty plaguing the business sector. Deteriorating conditions in macroeconomic stability, governance and the power sector have overwhelmingly been the most serious obstacles facing firms.¹²⁸ Yet as discussed below, for trade and export diversification, the empirical analysis of firm productivity raises the possibility of a deeper duality in the transmission of investment climate impacts to a firm's productivity and export competitiveness,¹²⁹ having important implications for new entry, deepening of the extensive margin and health export diversification.

221. While comparative productivity distributions over time show a promising decrease in the concentration of firms around low productivity levels, the productivity increases that were associated with investment climate improvements were transmitted through larger market share, formalized firms which are most likely to be the exporters of the country—as compared with the more informal smaller firms making up the bulk of Pakistan's enterprise sector. In other words, aggregate productivity gains have been coming through the few firms with a high weight in the enterprise sector, as opposed to productivity gains across a large number of firms with low productivity exiting from the market, as is observed in countries such as Chile, Mexico and South Africa.¹³⁰

222. Consistent with the firm level analysis of trade outcomes in Chapter II, market frictions exist, preventing convergence of productivity and firm level growth within the enterprise sector that is normally seen in dynamic economies. In Pakistan, large market share firms co-exist with smaller, less formal and lower productivity firms, producing at low level equilibriums, signally barriers to entry and exit as well as hindrances to firm level growth possibilities by smaller firms.

223. Though the production function approach makes it difficult to untangle competitiveness based on efficiency from market power and profits based on tax, pricing or concessions, certainly growth limiting market frictions exist from poor contract enforcement, limited domestic markets, entry and exit barriers, and regulatory aspects of firm level governance. Global evidence supported here is that improvements in these areas would help the small and medium firms the most.

224. The analysis also highlights the transmission of the investment climate to improved productivity and export competitiveness. While infrastructure, economic governance, finance, labor and innovation all play an important role in firm level performance, various aspects of these investment climate dimensions affect different firm groups in different ways depending in part, on the specific nature of the firm. Variables which reflect more *formality* (sales reported to taxes, court usage, having a bank account and working capital finance from banks) are positively associated with export competitiveness, regardless of the size.

¹²⁸ Between 2002 and 2007 the share of firms considering power as a major constraint rose from less than 40 percent to 80 percent. Similarly, despite spending less time on regulation compliance, managers considered that the prevalence of corruption was high and rising.

¹²⁹ In this discussion, firm level productivity is taken as the key to trade competitiveness and a firm's ability to introduce new products, processes, and other innovations – the underpinning to health export diversification.

¹³⁰ Pakistan enterprise surveys, 2002, 2007 and 2010 were analyzed for this section.

225. Specifically, positive aspects of the investment climate such as access to *finance, innovation, and skills training* were transmitted through large market share firms to export competitiveness. The enterprise sector as a whole, does not identify constraints in these areas as high priority, reflecting the low level demand for these services by the bulk of firms. However, the larger export oriented firms which do need these inputs, claim a significant deficiency in access to them.

226. Conversely, variables with a negative impact on firm's competitiveness such as power outages, internal or informal finance and concentrated shareholding, are transmitted principally through smaller market share firms. Similarly, the variables which relate to *firms' ability to cope* with these negative impacts on business (own power generation, security expenses, location in industrial zone, large inventory) are associated with productivity and employment with the positive impact dominated by large firms. As the analysis underscores concerns regarding deeper areas of *governance reform*, the deficiencies in predictable, transparent and effective systems to protect property rights and enforce contracts suppress arm's length business relationships, risk taking, and innovation, while constraining firm entry, exit, formality and growth.

227. While the impact of various investment climate variables on productivity is relatively robust across provinces and firm size, *firms' perceptions across provinces* show notable differences, which have much to do with governance, land availability and power sector issues. The *service sector*, in the area of domestic trade is smaller and more informal, is markedly different as compared with manufacturing. As compared with manufacturing, there is more emphasis on economic governance than infrastructure and finance—particularly in those areas which represent business-government interface and manager's time on regulation.

228. The policy analysis is based on an analytical framework for prioritizing areas of investment climate constraints for devoting various types of attention. In some key areas, such as power, labor, tax, business entry, licensing and financial sector a considerable number of reforms are ongoing and require deepening, but in others, deep seeded and entrenched areas of governance reform require attention to unleash constraints to firm level growth. Such governance issues include rising concerns about corruption, the need to better define and protect property rights, speedier and more certain contract enforcement, better regulation of markets, and the elimination of biases in the system against large, formal industrial firms in terms of tax, energy pricing, credit allocation, etc.

229. The analytical framework underscores the priority of having good macro, trade and competition policy in place while focusing attention on critical investment climate areas. As the economy undergoes a strenuous adjustment to past policy conflicts and current market turmoil, the authorities place macroeconomic management and a strong safety net at the top of the policy agenda while maintaining a commitment to an open, competitive trade and foreign investment regime. To sustain these goals over the medium term, a strong investment climate is needed and return to a strong growth path, deeper analysis and policy recommendations are made along the following four areas:

- *Removal of infrastructure constraints particularly in the energy sector.* The power sector's inadequacies have damaged manufacturing growth with supply constraints reaching a critical point. Unlike other areas where differences exist across size groups, sectors and geographic areas, there is universal agreement regarding the primacy of the power sector issues as an investment climate constraint. In addition, the notable improvements in telecoms and logistics remain undervalued by an aging and inefficient transport system.

- *Strengthened governance of market mechanisms.* Though improving in recent years, antiquated laws, regulatory compliance and red tape at various levels of government are still problematic, burdensome and costly. More importantly are areas related to corruption in business-government interface, property right protection and contract enforcement, speedier and more certain mechanism for corporate exit and elimination of biases in tax, labor, financial and energy pricing which hinder the incentive to grow and formalize.
- *Increased depth and improved functioning in labor, land and financial markets.* Though firms consider access to these factors less of an issue than other constraints such as electricity or governance, the analysis points to a low level equilibrium in these areas. In the case of labor markets, low skills are only a problem for the few firms which have an educated labor force. In finance, large established firms have access to standard relationship banking, but new entrants are shut out. Risk based or capital market products are non-existent.
- *Attention to firm level technology adaptation and the role of public private partnerships (PPPs) in spearheading progress.* The low level of technology used by Pakistan firms has at its core both demand and supply side issues. In addition to infrastructure, PPPs should be investigated, as applied to public goods in cluster development, environmental and social standards, technology upgrading and quality assurance. New, risk based financial products are also required to support entrepreneurship and innovation.

C. Providing Basic Infrastructure for Commerce

230. High quality and reliable infrastructure access to electricity, water, transport and trade facilities is a key component of economic competitiveness, and a central pillar of a conducive investment climate, requiring attention at all levels of government and the private sector as important infrastructure dimensions of competitiveness. Business losses due to power failures, insufficient water supply, inefficient transport services, and delays at ports significantly impact costs and risks for firms, create impediments for opportunities and compromise investment interest. The recent Global Competitiveness Report (GCR) 2011-12 ranks Pakistan at a modest 87 out of 133 in terms of Quality of Infrastructure – after Sri Lanka (63), higher than other South Asian countries including India (89) and Bangladesh (125). It also masks higher rankings in rail (51), roads (65), ports (73) and air (76). More than these needed improvements, power is the immediate issue.

231. The power sector in particular, has proved to be a major bottleneck for the economy and a serious threat to overall competitiveness. The GCR ranked Pakistan 124 in terms of the overall quality of electricity supply in 2009-10, far below the overall infrastructure rank of 87 cited above. Inordinate delays in obtaining new power connections significantly impede the ease of entry for new businesses while seriously constraining existing firms in planning business expansions. Even firms with access to electricity face high costs and highly unreliable supply of power with frequent outages, disproportionately affecting firms in different regions. Relative to comparators, firms in Pakistan suffer the most severe financial losses due to power interruptions, with small firms and the textiles sector bearing the highest losses. It is difficult to generalize about prices of electricity relative to other South Asian countries given the amount of technical, collection and efficiency losses in the system. Cross subsidization by industry to households also complicates pricing calculations and imposes a strain on the sector's sustainability.

232. Growth in electricity consumption in recent years has exceeded earlier projections with this demand pattern expected to continue with high growth for next few years. Currently planned investments are unlikely to suffice. New investments will be required to enhance generation capacity.

Increasing energy efficiency and diversifying the available energy mix will help. The power sector will have to be made financially sustainable to enable better maintenance and future expansion. There is also need to make structural reforms and adjust the regulatory framework to enhance effective corporate governance in the sector. The GOP has also been wrestling with how best to encourage more private sector participation and investment to meet the generation gaps in this sector.

233. Pakistan's transport sector is operational but inefficient with expensive ports, unreliable rail, poorly maintained roads, stagnant aviation, and under-developed logistics. The relatively high costs, slow turnaround and low reliability of transport constitutes a drag on Pakistan's economic growth, reducing the competitiveness of the country's exports, and constraining the ability of the country to integrate into global supply chains. Policies that reduce transport costs, ensure safety in mobility, and enhance regional connectivity by creating greater synergy between the rural, provincial and federal transport infrastructure will help to increase Pakistan's competitiveness, raise its share of world trade and foster regional integration. A better transport and facilitation sector will also bring about structural changes in the industrial and services base through better economic mix, value addition and job creation.

234. Pakistan has devoted considerable resources and effort to improving trade logistics which have borne fruit, both in terms of concrete outcomes and firm perceptions. As a compliment to the significant reduction in tariffs and border taxes that have led to a significant increase in trade volume, the GOP has taken important steps to improve the time and cost for clearing trade shipments, particularly at the Karachi Port, through simplified procedures, paperless, electronic clearance systems and linkages with banks. The result has been a model of reform that has reduced the time between clearance and exit from the port from about 7-1/2 days to 1 day or less. Now, with the exception of firms in NWFP where the issue is more domestic transport to ports and airports, rather than trade logistics per se, managers no longer consider customs and trade to be a significant obstacle.

235. The infrastructure challenge is particularly acute with respect to water. Competition for water is growing among the provinces and across the varied needs for irrigation, industrial and domestic use, and the environment. Due to the nature of its production process, the food sector is the most water-constrained. Quality and reliability of water supply are bigger issues for firms in Pakistan compared to access and the GOP needs a sustainable and long term strategy to address maintenance and development of assets in this sector. As investment is severely constrained in the water sector despite high returns, nontraditional methods for financing infrastructure involving the domestic and foreign private sector, securitization and privatization of existing assets, and PPPs can be explored.

236. The GOP's reforms in telecommunications have resulted in impressive growth for the sector and made it the least constraining infrastructure obstacle for firms in the country. Both line and mobile penetration have increased nationwide, particularly in rural areas. The increasingly competitive environment has driven down tariff rates that are now among the lowest in the world. However, in contrast to the very high level of voice penetration, internet adoption in the country is very low by international standards. One reason is that the telecommunication policy and ICT policy have been driven separately and thus are headed in different directions – a looming problem as the country prepares for 4G and rural role outs.

237. The private sector's involvement in provision of infrastructure services is sporadic and far behind the neighboring countries. Pakistan has had significant success in attracting private investments in the telecommunications sector in the 1980s and the power sector in the 1990s and

aims to deepen that success while broadening to other infrastructure areas such as transport & logistics, water supply, effluent treatment, and irrigation. Progress to date includes a legal framework for PPP, the establishment of the Infrastructure Projects Development Facility (IPDF) and the recent adoption of a PPP policy. The next steps, on the public side, would be a more specific institutional, set up with clarity on public management at the IPDF and related agencies, of the (i) deal making process, (ii) legal and operational risks, and (iii) financial obligations and contingencies. The provincial governments, specifically the Government of Punjab is also working toward developing a comprehensive PPP framework, and plans model transactions in power, waste management, toll roads, and others. On the private side, the mobilizing of domestic resources to invest in such new PPP type of vehicles will create major demands for financial sector deepening and corporate sector transparency.

238. With regard to the way forward, an urgent and aggressive redoubling of reform efforts throughout the infrastructure is required. Higher rates of investment, for example through a fully developed and tested PPP system, as described above are needed to generate additional electricity, relieve power shortages and prevent load-shedding. On the demand side, power efficiency needs to be encouraged through price and non-price means. The sector needs to continue to strive for financial sustainability to enable better maintenance and future expansion while the tariff structure needs to create as much as a level playing field as possible for all users to make the right decisions. In the long run, energy mix diversification should be a key strategic element.

239. In terms of non-power infrastructure, the urgency is lower but no less needed to ensure that Pakistan can compete in a global environment. The National Trade Corridor Investment Project (NTCIP), as the medium-term policy framework for the transport sector, has recorded some early gains but progress is needed to address the transport sector's main beneficiaries. A small success, such as scaling up the customs pilot, is an urgent, straightforward and achievable goal to get started. In the water sector, the Government needs a sustainable and long-term strategy to address maintenance and development of assets. In telecommunications, the regulatory framework and telecom policy need to keep pace with the fast-changing dynamics of market evolution.

D. Strengthening Economic Governance through Better Regulation

240. Business regulation has become less intrusive over the past decade, but deep seeded institutional factors remain a hindrance to a more conducive business environment. While the country has done reasonably well by international standards in achieving a less burdensome regulatory environment, it has lagged behind with respect to protection of private property rights, corruption, quality of judiciary, and the law and order situation. These factors affect the economic governance of markets, business relationships and are important determinants of productivity. In the productivity analysis, for instance, statistically relevant *governance* variables affecting both average and aggregate productivity include “sales reported for taxes”, “gifts to tax inspectors,” “payments to obtain government contracts,” “losses associated with crime and expenses on security,” as well as “the use of courts for conflict settlement.”

241. On the regulatory front, the GOP's efforts at lowering hurdles for business have had a positive impact on firm productivity and enterprise perceptions of the investment climate. In the 2009 Doing Business rankings, Pakistan ranked 77th in the world in the composite index of 10 indicators—the best for South Asia, apart from the Maldives. At the same time, firm managers report much less time dealing with regulations as compared to other countries and indeed compared to Pakistani managers only five years ago. Notably, tax administration which was the second ranked obstacle in 2002 when half of firms

consider it a major obstacle, was in 2007 the eighth most important. Similarly, the various efforts to improve interface with labor inspectors at the provincial level and better customs administration at the ports has also had a positive impact. The challenge now is to deepen the effort on the business regulation front at the federal level and involve more directly provincial and district level government to streamline and unify systems nationwide.

242. On the institutional front, difficult challenges remain as notable improvement requires sustained, long term efforts across a number of fronts. The perception that the quality of courts are an obstacle is expressed by over 36 percent of Pakistani firms compared with approximately 20 percent in comparator countries. This is especially so for sectors such as chemicals which require long-term investments. Firm-perceptions about court speed are reasonably good in Pakistan but lag far behind other countries in impartiality and affordability of courts and especially in the enforcement of court decisions.

243. Crime and security is not as big a problem as corruption in Pakistan but a third of firms perceive it to be a serious obstacle. Expenses on security far exceed losses due to crime in Pakistan, and there is a wide variation among firms—based on size, location and sector of operation—on crime-related expenses and losses. Industrial zones solve many of the infrastructure, agglomeration and indeed law and order type of problems but have failed to provide a corruption-free environment. The number of firms reporting corruption as a major obstacle to business rose from 40 percent in 2002 to 57 percent in 2007 and was even higher for firms which had interface with tax and labor officials, applied for utility connections or licenses, or received financial support from the government.

244. Though Pakistani firms do not express serious concern about the competition from the informal sector, informality is nonetheless a challenge to global competitiveness. Informality is often defined as avoiding regulations, using informal factor markets – land, labor and finance and/or just being small since business laws cover only firms with more than 10 employees. In Pakistan, the incentives to be informal in some way are enormous, given the difficulty in enforcement and the high burden on formal firms. The result is that firm size remains small, outlook stays local – avoiding arms length transactions with suppliers, banks and customers, and managers lack incentive to augment quality or train labor. As global experience suggests that imposing major constraints creates incentives for businesses to remain informal, good regulatory administration can positively influence the degree of informality in Pakistan.

245. Applying a sound regulatory system and non-distorting product and factor market policies will eventually reduce the incentive for and degree of informality in the system. In the short run, progress in the area of business regulation has had demonstrated effects on the perceptions and efficiency of the business community. However, the performance – for example in business taxation – has not reflected improved administration and collection performance, just less hassle on business. Therefore, more effective administration also requires improved policies – in this case, biases which prevent more neutral application of the tax code across activities.

246. In the end, free entry, good resource allocation and buoyant firm level growth requires strengthened property rights, enforced contracts and speedy dispute resolution. To ease corporate entry, further streamlining of business licensing and property registration areas can be pursued through automation and business process engineering. Reform of some key business regulations requires an effort to encourage provincial authorities to engage in process analysis and re-engineering. The legal framework for companies requires a comprehensive revision, particularly of

those aspects dealing with insolvency and liquidation. Finally, a good investment climate requires more than the removal of immediate constraints—it also needs to improve public-private cooperation. With the exception of firms in the textiles and sports goods, few others in Pakistan participate in a public-private dialogue.

E. Achieving Flexible Labor Markets and Enhancing Skills

247. A key challenge to the investment climate is how to enhance skills levels and capture the returns to education. A more flexible legislative framework for labor markets is needed to increase autonomy of firm decisions about hiring and firing while providing adequate levels of labor protection and safety. The Pakistani labor market contains a large informal sector while another large share of the workforce, particularly in manufacturing, holds temporary jobs and works on short contracts. In contrast with the large proportion of service sector firms, few manufacturing businesses in the country provide formal training to their employees. This is on top of the fact that more than half of the country's workers have less than three years of education.

248. Despite low levels of education and a rigid labor code, firm managers in Pakistan do not perceive skills, quality of workforce or labor laws to constrain business. This perception does not correlate with actual data and analysis which shows that returns to business increase with progressively higher levels of education. In addition, according to Doing Business indicators on labor market rigidity, Pakistan ranks poorly – worse than Bangladesh, Chile, the Philippines, South Africa, Thailand and Turkey. The primary reason for the distinction is weak enforcement, as firms are able to find ways to circumvent strict regulations, such as hiring temporary workers or participating in informal labor markets (e.g., hiring through third parties).

249. Strict labor legislation combined with weak enforcement has many adverse implications for the fluidity of labor market and the incentives to invest in training. These practices may hamper employment growth in the long run as they increase labor market inefficiency and limit the mobility of workers. For example, when term contracts are limited in scope and duration and constrained autonomy is granted to firms with regard to hiring and firing decisions, the working of the formal labor market is severely restricted, as it is in Pakistan. In addition, the adjudication mechanism for firing or retrenching involving provincial Labor Tribunals is complex, making outcomes uncertain. Finally, despite mandated benefit packages for workers, the high taxes are avoided by hiring labor through informal channels. Since the benefits do not effectively accrue to workers, they are not demanded. Therefore due to legislated restrictions on hiring, judicial challenges to firing, and expensive mandated benefits, many firms in Pakistan hire temporary workers to increase autonomy and flexibility while reducing costs.

250. In terms of the way forward, these study's findings point to a need for strengthened education and improved legislative underpinnings for labor market fluidity. Strengthening the public and private provision of the education system is a fundamental necessity for promoting innovation and improving productivity. Providing incentives to increase firm training and foster transferable skills among workers is important to promote innovations and enhance firm productivity and requires a major labor code reform which is now underway. The first major steps have been taken in terms of the legislative process, with a pipeline of major activities about to be launched. In addition, the enforcement of these combined federal laws will require reforms of the inspection regime which ensures minimized red-tape, bureaucratic hassles and extra costs on businesses. Developing a labor inspection policy framework to reorganize and streamline labor inspection services, and eliminating corruption during inspection, should go a long way towards encouraging more employment in the country's formal sector.

F. Expanding Corporate Access to Finance

251. The financial sector in Pakistan is dominated by banking activity which was bolstered by deep and fundamental reforms in banking initiated over the past decade. In addition to the banking sector being one of the fastest growing and most profitable in the region, it remains relatively sound and appears to have been surprisingly resilient in the face of macroeconomic challenges faced by the economy over the past two years. Stress testing in the summer of 2008 showed pockets of weakness, but generally revealed resiliency in the financial structures. In examining the impact of terms and conditions associated with credit products on credit usage, it is seen that lending rates have been low in real terms as are processing fees. However, the terms of loans are much shorter and loan sizes larger in comparison with other countries. Bank requirements for collaterals against loans are higher compared to global competitors.

252. In addition to its safety and soundness concerns, efforts to encourage more diversity in bank lending have been a policy goal of the State Bank for some time. Corporate lending has remained the primary business at almost two thirds of the banks' lending portfolio but access to financial services and products by non-corporate clients remains low compared to countries with similar income levels. Beginning with efforts to expand into consumer lending in the early part of the decade and to encourage SME lending in the form of specialized prudential and regulatory norms, SBPs efforts have had a positive result in terms of the stated goals. Such efforts have helped in this respect but, as a percentage of total lending, the share of SME finance has decreased from 2004 through 2007 as firms have remained focused on large groups and consumer lending. The State Bank is also look for increased activity in longer term activities by bans, such as in the area of housing and infrastructure finance.

253. Financial sector reforms have had a significant positive impact at the firm level but have a long way to go to increase the financial deepening needed to support growth. The domestic firms' perception that access to finance as a major obstacle to the investment climate has reduced considerably between 2002 and 2007 and what was the 5th ranked obstacle is now ranked 9th. At the same time, the productivity analysis shows that access to bank financing is associated with higher productivity with the line of causation likely going in both directions. However, non- "blue chip" companies still find it challenging to secure finance and rely instead on retained earnings to finance working capital and investment needs. As a result, trade credit plays a smaller role in working capital financing as compared to other countries. The predominant reason cited by firms of all sizes is lack of access of own decisions to opt out of the formal credit market for a number of reasons. As a result, the financial outreach to businesses in Pakistan is limited, with small and medium firms showing significantly lower rates of credit usage as compared to large firms.

254. Gaps and deficiencies in the institutional framework limit the propensity to lend and borrow. Such gaps include the enforceability of legal and contractual rights of lenders and borrowers, prudential regulations and supervision which encourages banks to diversify their lending while maintaining sound and prudent lending practices and more extensive use of credit information. Therefore, burdensome requirements for risk management, lack of transparency for credit decisions and prudential regulations that allow banks to focus on large, known groups, may be among the factors driving low credit use by firms other than the known big players. Improvements in these institutional areas will enable greater outreach, more tailored products and better terms of lending.

255. In terms of the way forward, a range of reforms is needed to increase the depth and outreach of finance. Prudential regulations allowing high concentration on single party and single group

exposure should be made consistent with international norms. Reconciliation and strengthening of the supervisory role of the State Bank of Pakistan (SBP) and the Securities and Exchange Commission of Pakistan (SECP), including jurisdictional clarity in some cases is needed to ensure the sector's safety and soundness and encourage financial deepening. Strengthening the enforcement of contracts is paramount to increasing financial access by fostering arms-length transactions between firms and between lenders and firms. In particular, reforming collateral systems and establishing a national internet-based filing archive of security interests in movable collaterals would allow firms of all sizes to better exploit their productive assets to secure credit. In addition to moveable collateral, better enforcement of ownership rights when it comes to land titling is an urgent but difficult area. While greater access and outreach to individuals could have a multiplier effect on enterprise finance, outreach would also be fostered by improving and deepening credit information systems in order to lower perceived risk.

G. Absorbing Technology and Fostering Corporate Innovation

256. In the present global environment, higher rates of technological absorption, better organizational methods and faster innovation are essential for firms to compete. The current competitive environment for products in Pakistan's specialization consists of access to global value chains, shortened product life cycles, and for more differentiation in product design and development. Yet in spite of significant deregulation and privatization initiated in the 1980s, the Pakistan economy remains burdened by many inefficiently run enterprises and an industrial structure dominated by low technology products. Despite ample opportunities to develop local information technology (IT) and IT enabled services (ITES) industries, the indications are that most Pakistani firms have not yet embraced IT for use in their own daily business activities.

257. Innovation can be obtained through absorption of own produced technological advance and by acquiring already produced technology and adapting it to local conditions. In terms of own produced technology, research and development (R&D) activity in Pakistan is dominated by the Government without the complementary private sector R&D investments needed to foster commercially viable innovations. The number of firms applying for patents, innovating via the introduction of new products, or upgrading existing product lines is very low in Pakistan. The U.S., among others, has demonstrated how technology often geared for military uses, has found its way to commercial applications, but there was a heavy need for private R&D in the process of conversion. Pakistan has also been unable to attract off shoring R&D activities by multinational firms, primarily due to a poor investment climate for protection of investor rights and a lack of relevant educational attainments in its workforce.

258. On the other hand, of greater concern is the fact that Pakistan does not seem to access existing, readily available technology through trade, FDI and licensing. High-technology represents an increasing but very low share of Pakistan's total manufacturing exports and imports. Low technology goods, mostly textiles, make the bulk (more than 75 percent) of the exports while nearly all segments of the textile sector, from cotton cultivation to manufacturing of garments, lack modern technology—compared to competitors such as Indonesia, Korea and Turkey which have used the latest technologies to help capture and sustain global export market shares. At the same time, net FDI inflows as a percentage of GDP in Pakistan have been increasing steadily but are lower than those in other comparator countries with recent events in the country causing the bottom to fall out of foreign investment market.

259. Traditional forms of technology transfer are not being used to the extent possible and could be more aggressively pursued by all parties. Alliances and joint ventures could be used more to

transfer technology as is licensing as a traditional technology transfer mechanism for firms in developing countries. As Pakistani firms are far behind in obtaining quality certification of the type attractive to international partners, one approach would be for the Government to encourage the adoption of industrial standards to promote quality upgrading, enhancing competition, and diffuse technology.

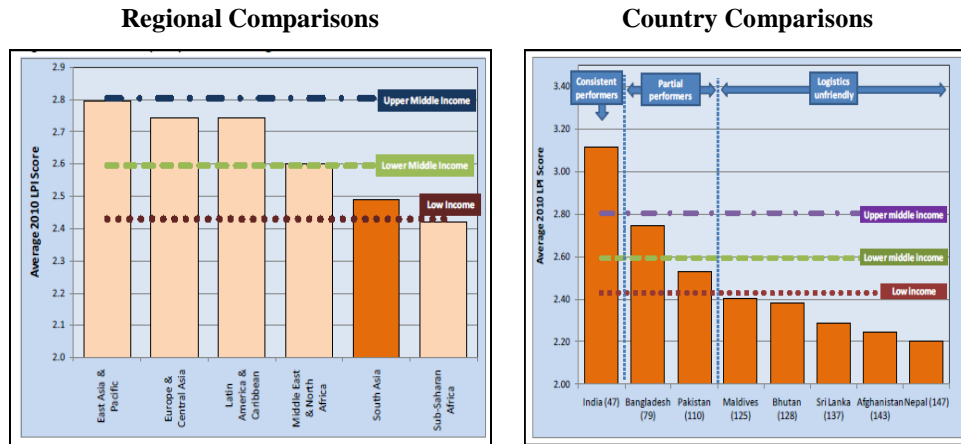
260. Governments at all levels can play a vital role in creating incentives for firms to invest in riskier technologies as well as crowding in investments that serve a public role. As Pakistan pursues technology transfer and absorption, it is critical for policymakers to keep in mind the importance of the sequence of efforts. Such a sequencing approach should be integral to the overarching science and technology policy in order to provide clear strategic focus for strengthening the incentive regime to better foster innovations and encourage firms to internalize productivity gains from local and global innovation spillovers. This will require first, a conducive investment climate based on appropriate returns to risk, availability of corporate and risk based finance, such as venture capital, a competitive environment and the provision of quality infrastructure, including power, transportation and communications. Second, an enabling environment for risk taking may require focus on creating stronger regulatory and enforcement framework for electronic data protection, intellectual property rights (IPR), and cyber crime as well as a sound judicial system to enforce them. Finally, necessary public goods should be developed such as skills development, quality certification by a recognized accreditation agency and standard upgrading to promote exports.

261. More directed actions may also be appropriate to strengthen Pakistan's stance as a knowledge-based economy. For example, as noted above, adopting new technologies will require investment in new skill development, which due to the lead time involved and the spillover impact, may be subsidized by the public sector, facilitated through directed programs at Diaspora and supported by investment in polytechnic institutions. Narrowing the technology gap also requires that considerable resources be directed towards specific infrastructure development in order to raise the currently low penetration of the broadband network. Bridging institutions like incubators, science and technology parks and technology transfer centers can be focal points for PPPs to directly facilitate local innovation. Finally as the development of knowledge transfer linkages between industry and academia remains a major challenge for Pakistan, technology adoption schemes financed through matching grants could be powerful tools to kick-starting innovation.

H. Trade Facilitation and Logistics for Exports

262. The GOP has long identified transport and trade logistics as bottlenecks to sustained export performance and diversification. As trade logistics involves the working of various pieces of a system, this chapter looks at measures of performance, quality of services and degree of integration of the logistics system as a whole to identify the main areas of concern. Generally, the South Asia neighborhood as a region lagged behind most regions, only surpassing Sub-Saharan Africa. South Asia fared in line with its per capita income, performing marginally better than the low income country group. Based on the 2010 Logistics Performance data, Pakistan's logistics performance trailed Bangladesh and India and the global average (Figure 43).

Figure 43. Logistics Performance, 2010



Source: PRMTR, 2011

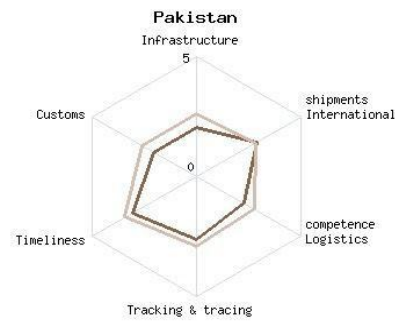
263. Pakistan's core transport and logistics system supports trade in various commodities of varying cost, time and reliability sensitivities, ranging from agricultural products to electrical and other manufactured products, but services are of low quality when compared to countries of similar levels of income. In the main, the LPI data point to weaknesses in Pakistan's performance in infrastructure, customs and logistics competence (Figures 44 and 45).

Figure 44. Pakistan's Comparative Compared to India



Source: Text

Figure 45. Logistics Performance Index, 2010 Compared to Global Average



1. Road Transport and the National Transport Corridor Improvement Program

264. Road transport is the dominant mode of overland transport in Pakistan, accounting for more than 80 percent of cargo volumes shipped, most of which is over a National Trade Corridor.¹³¹ The core network of highways, now some 1930 km, is being extended under the NTCIP with new restricted access motorways being constructed. The main artery, connecting Karachi to Lahore and

¹³¹ The NTC network is the north-south corridor through the center of the country and is comprised of the two ports in Karachi, the highways and railways linking them to Islamabad, Lahore and Peshawar, the four major airports serving in the main centers, the various dry ports and the Pakistan/Afghanistan border post at Torkham.

other centers to the north is 1760 km long and carries over 55 percent of the country's inter-city traffic. The other national highways include the Indus Highway, the RCD Highway and the Karakoram Highway. Nearly two-thirds of the network is in poor condition. This is primarily due to inadequate maintenance made worse by overloading and the shift of traffic from rail to road.

265. The NTC is the single most important trade and transport system in the country, handling more than 95 percent of Pakistan's external trade, 65 percent of total land freight and serves regions of the country that contribute 80 to 85 percent of GDP. The NTC connects Pakistan's major gateways for trade which are in the south and the key economic centers in the center and northern parts of the country. The greatest concentration of economic activity takes place along the corridor, along the Peshawar-Islamabad-Rawalpindi-Lahore road and a portion of Lahore—Karachi road. The Pakistan National Trade and Transport Facilitation Committee (NTTFC) was created in 2001 initially to implement a trade facilitation program financed by the World Bank. It was established under the Ministry of Commerce with the Pakistan Shippers Council providing secretariat services. Membership of the NTTFC is made up of both public and private sector representatives and includes various government ministries, industry associations and the main modes of transport (road, sea, air, railways). The NTTFC seeks primarily to promote reforms to improve trade facilitation environment in the country. Its terms of reference are:

- Continuous review of trade and transport procedures and systems with a view to update their simplification and harmonization.
- Undertake coordination of efforts of concerned organizations in the field of facilitation of international trade and transport.
- Collect and disseminate information on international trade and transport formalities, procedures, documentation and related mailers.
- Pursue the simplification and alignment of trade and transport documents on the basis of United Nations layout key, including documents designed for use in computer and other automated systems.
- Promote the adoption of the standard trade and transport standard terminology and international codes for trade and transport information.

266. The NTTFC has invested considerable energy on trying to improve the legal framework for trade facilitation and logistics in Pakistan. Though some progress has been made in this regard, it is also apparent that the body lacks the power to bring its initiatives to fruition. This is despite the fact that it is dominated by public sector borders, which would have been expected to more easily influence policy. Perhaps this is due to the fact that the NTTFC activities lack the practical orientation that a more focused body would bring. As discussed below, there are prospects that a regulatory authority proposed for the logistics services sector may help overcome this constraint. The NTTFC would then be a stakeholder consultation forum and a performance monitoring body, relying on data from both the public and private sectors.

267. A National Transport Corridor Improvement Program (NTCIP) was launched in 2005 as a major initiative to reduce the costs of trade by reduce or eliminate bottlenecks and improving the performance of the national system for transport and logistics services.¹³² The NTCIP was conceived

¹³² Analysis estimated the cost of inadequate transport at 4 to 6 percent of GDP per year. (SASD, 2008).

as a comprehensive multi-sector reform and investment effort covering the streamlining of transport and logistics procedures, improving services and upgrading physical infrastructure in railways, roads, ports, airports and logistics (Table 21).

Table 21. Key Components of the National Trade Corridor in Pakistan

Component of the NTCIP	Description
Roads	955 km of highways linking Karachi, Lahore and Peshawar
Railways	Main line railway from Karachi to Peshawar via Lahore
Ports	Karachi and Qasim
Airports	All major airports
Dry Ports	Lahore, Faisalabad, Lahore, Islamabad, etc
Border Posts	Torkham with Afghanistan

268. Karachi sits at the core of the NTCIP as it is the transport and logistics node, handling more than 90 percent of trade. Though Karachi is already well established as the gateway for national trade, its success as a regional gateway would depend on improving the performance of its seaports and air transport services. One objective of the NTCIP is to develop Pakistan as a regional logistics hub, serving neighboring countries as well as transit traffic along the major east-west international maritime transport lane. Some of the proposals in the NTCIP are clearly aimed at such improvements. Among others, the key policy areas targeted by NTCIP include policies that would: (i) lead to modern and streamlined trade and transport logistics practices; and (ii) improve port efficiency, reduce the costs for port users and enhance port management accountability. Still, for Karachi to emerge as a hub its performance and efficiency would have to surpass that of established hubs in its immediate neighborhood.

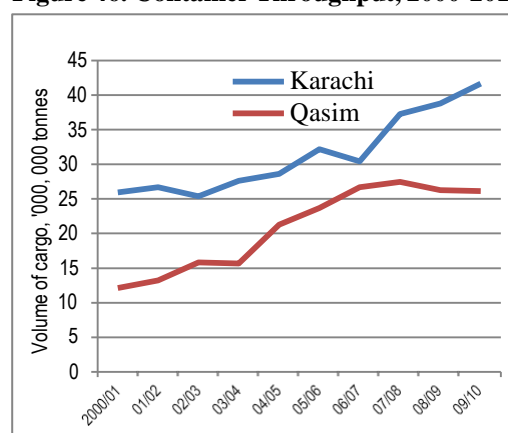
2. Karachi in a Multi-Hub Neighborhood

269. More than 90 percent of Pakistan's international trade is transported by sea. The trade traffic passes through Karachi where there are two container terminals, the Karachi International Container Terminal and Port Qasim. Of the two, the Karachi International Container Terminal (KICT) handles the most volumes (Figure 46). All major shipping lines provide services to either Karachi or Qasim. However, connections to Europe are indirect, with hubbing mostly through Salalah in the Middle East.

270. Based on traffic volumes, Karachi is ranked 75 worldwide, exceeded by eight ports in its immediate neighborhood (Table 22). It is therefore important to acknowledge that success in developing Karachi in particular as a regional logistics hub would depend on operational efficiency and cost, or the development of a nice port, in order to compete with the seaports in the Middle East.

271. In the past seaport operations in Pakistan were characterized by high cargo dwell times in the ports, resulting in higher charges to users than might be considered as desirable in terms of overall economic policy, increasing openness to the world economy and stimulating trade. In an effort to encourage fast removal of cargo, both ports reduced their free storage periods from seven days to five

Figure 46. Container Throughput, 2000-2010



days in 2006 while port tariffs and performance are now monitored and measured against similar indicators in other regional ports.

272. A second issue facing Karachi Port Terminal is the presence of Karachi Dock Labor Board (KDLB) which perpetuates a system of labor practices that is not conducive to high productivity at low costs. Work to terminate the KDLB has stalled since 2007 while reduction of its influence is now occurring via natural attrition.

273. The Pakistani ports of Karachi and Qasim are feeder ports while the most of the ports in the region are hub ports (Table 23). They handle mostly domestic and Afghanistan transit cargo. Logistics hubs emerge and prosper based on their ability to reduce costs. Cost and time in logistics are in part functions of geography and as such in most cases the development of logistics hubs depends on the location of the hub relative to the major flows of traffic. A port is strategically located if it has at least one of the following three characteristics: location on the major maritime routes, situated in or near large center of production or consumption and has a deep natural harbor with significant landside development potential.¹³³ But determinants of logistics costs extend beyond geography and include the quality of infrastructure, the efficiency of business logistics, and effective trade facilitation institutions.

Table 22. Comparative Cargo Volumes

Dubai	UAE	11,600,000	10
Jawaharlal Nehru	India	4,270,000	26
Colombo	Sri Lanka	4,000,000	29
Salalah	Oman	3,485,395	33
Combined	UAE	3,022,524	39
Shahid Rajaei	Iran	2,592,522	45
Ambarli	Turkey	2,540,353	48
Karachi	Pakistan	1,370,000	75
Chittagong	Bangladesh	1,328,976	79
Mersin	Turkey	1,024,171	91
Djibouti	Djibouti	600,000	124

Source: Author estimates and data from Containerization International

Table 23. Transshipment Hubs for Pakistan Ports

Shipping Line	Pakistan Port	Transshipment Hub
Maersk	Qasim	Jebel Ali, Salalah
CMA-CGM	Qasim	Jebel Ali, Singapore
MSC	Qasim, PICT	Jebel Ali, Muscat
Hapag Lloyd	Qasim	Salalah, Jebel Ali, Colombo,
APL	KICT	Salalah, Colombo, Singapore

Source: Arnold, J. 2011

274. The time cargo stays in ports is at the forefront to improve the overall performance of trade corridors and supply chains. In Pakistan ports, the port authorities allow for up to 5 days of free storage time in the port. Recent statistics suggest that time spent on dwell time in Karachi is 7 days, demonstrating that Karachi's performance has been improving remarkably.

3. *Air Connectivity*

275. Air transport is the second most important mode of transport for international trade in Pakistan, handling more than 250,000 tons per year and passing through the main airports of Islamabad, Lahore and Karachi (Figure 47).

¹³³ UNCTAD (1992).

276. As it is in sea transport, Karachi is the main air transport node in Pakistan. The Pakistani combined passenger and cargo network is basically structured around the air links between Lahore and Islamabad and Karachi; and between Karachi-Dubai, the main destination outside Pakistan. The Karachi-Islamabad and Karachi-Lahore pairs dominate the domestic air transport services. When comparing the relative importance of cities within the Pakistani air services network, Karachi stands out as the most central.

277. There are approximately 1,000 weekly domestic flights in the country, of which almost 30 percent are accounted by the routes Karachi-Lahore and Karachi-Islamabad. Almost 25 cities have scheduled flights, of which 18 have regular services to Karachi. On the other hand, 230 international weekly flights connect Karachi with over 30 cities abroad, where almost a third are non-stop services to Dubai (Figure 48). Other destinations of importance from Karachi are Bangkok and Jeddah. In addition, only 4 or 5 weekly flights are available to most international destinations outside the Middle East.

Figure 47 . Air Cargo Volumes, 2000-2009

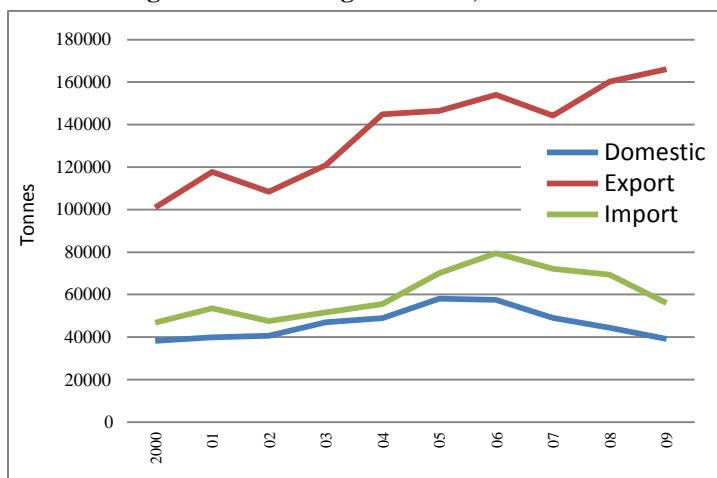
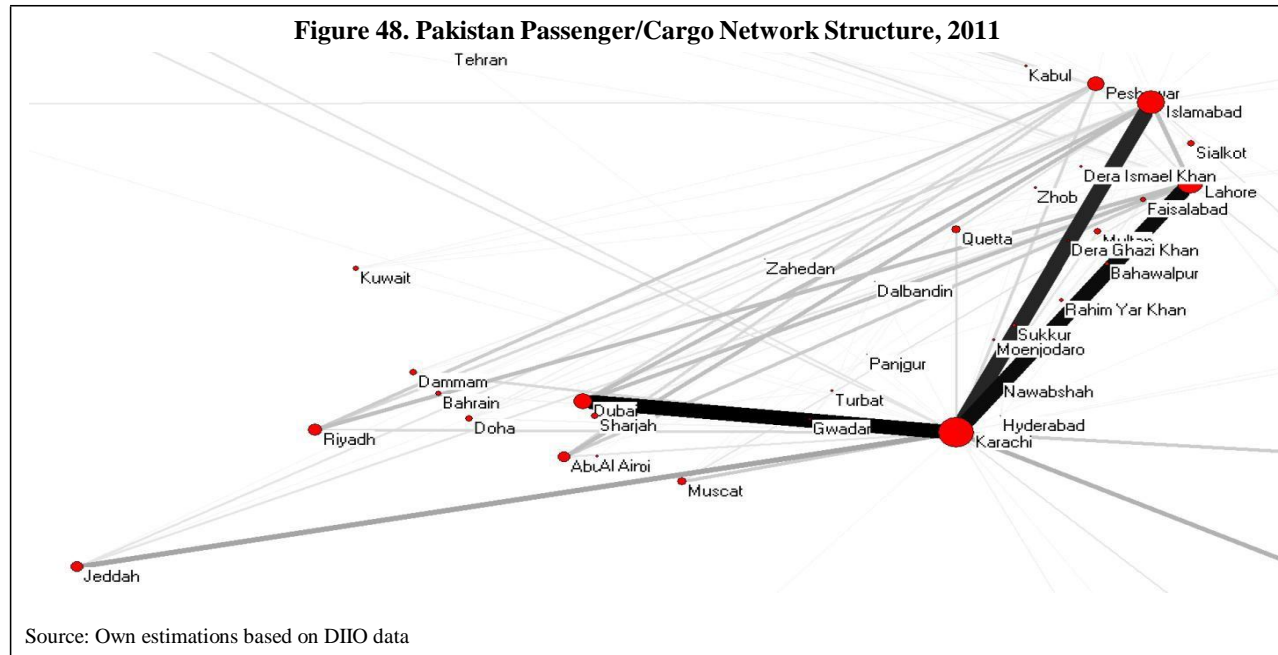


Figure 48. Pakistan Passenger/Cargo Network Structure, 2011



278. Pakistan sits astride main air traffic routes connecting Europe and the Middle East with Southeast Asia and Australasia. However, Pakistan's role in the worldwide airline network structure is far from central, and might present only limited opportunities for transit traffic. Given the preeminence of other hubs like Dubai and Bangkok that compete in the same through markets, it seems unlikely for Pakistan to become a credible connecting hub in the short run, especially for directional long haul connections between Europe and Asia. On the other hand, its geographical location might favor short and medium haul connections in South Asia and the Middle East.

279. Of the almost 30 air carriers serving the country, only three are from Pakistan. Five international carriers provide 40 weekly scheduled all-cargo services in and out of Pakistan; most notably the Emirati Etihad and Midex Airlines, as well as Qatar Airlines. The most frequently used aircraft in these routes to Pakistan is the A300 freighter version, with a maximum payload weight of almost 48 tons. Karachi, Lahore and Sialkot are the only cities with access to scheduled dedicated cargo services. Using the total turnaround cost methodology, Pakistani airports strike as one of the most expensive in terms of landing charges.

280. Key bilateral air service agreements govern the main traffic flows between Pakistan and its main destination countries—one of the most important ones being with the UAE. According to this agreement, Pakistani carriers can freely determine the frequency and aircraft type from any point of Pakistan to any point in UAE. On the other hand, Emirati carriers can only access Karachi under identical conditions, whereas the cities in North Pakistan are heavily restricted in the number of frequencies for Emirates' carriers.

281. Multiple designations have also helped to increase competition. The bilateral agreement with UK - one of the main destinations outside the Middle East - has free determination in frequency and capacity, and even grants full 5th freedoms to Pakistani airlines (although restricted to 6 weekly frequencies from any UK airports other than Heathrow and Gatwick). However, British carriers suspended operations in Pakistan a few years ago.

4. *Developing Logistics Clusters for National Connectivity*

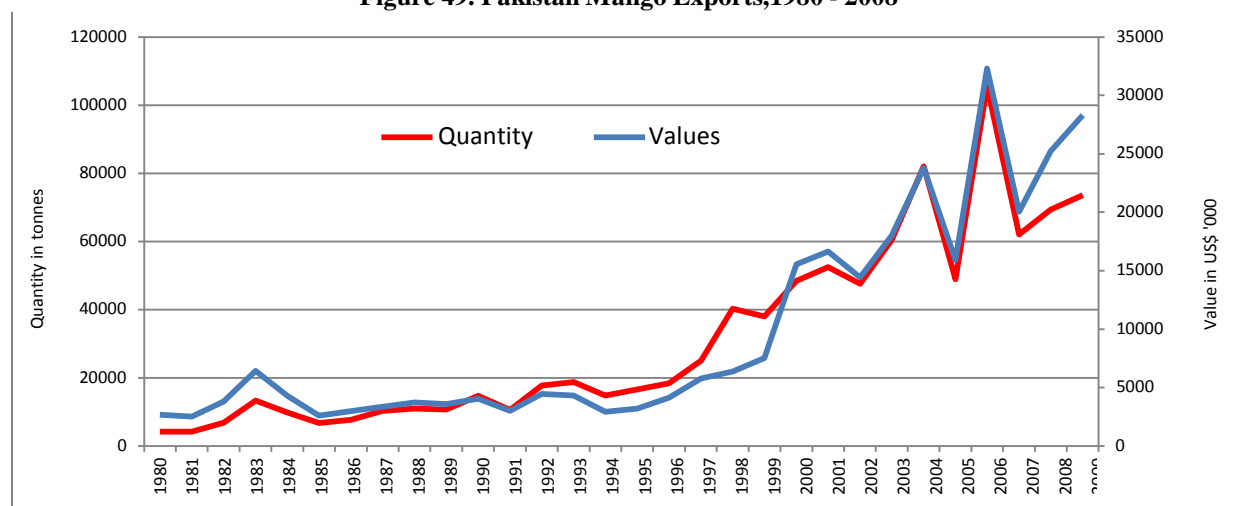
282. Given that the national logistics hub in Pakistan is located in the south of the country, geographical disparities in connectivity are inevitable. When moving to the north and west of the country and away from the core national corridor, there is reduced access to minimum quality infrastructure and services as the core region is better connected than centers to the west and north-west part of the country. Exporting from lagging regions therefore, would require better connections to the main export gateway.

283. Given the nature of some of the prospective export commodities, which have high volume to weight ratios and the distances involved, it would appear the key to improving domestic connectivity lies in developing multi-modal systems based on rail and road interconnectivity and consolidation of trade volumes. Consolidation could be facilitated through logistics clusters, inland container depots and dry ports.

284. For example, in the horticulture sector, mango exports have grown rapidly in recent years (Figure 49), due in large part to a shift from air freight to sea transport. However, there are two factors that reduce the likelihood of success in the transport of these types of products. First, production is dominated by small scale production, which when spread over large areas increases logistics costs as there are limited opportunities to exploit economies of scale. There is therefore a need for strategically located infrastructure for consolidation, grading, processing, packing, cold

stores to facilitate such trade by reducing cost. Secondly, these products though time sensitive, have large volumes and low values. This makes the more readily available mode of transport, which is air, unsuited to expanding their trade. Air transport is suited to high value products that are time sensitive. The challenge is how to develop an efficient land transport system that can connect producers in the northern part of Pakistan to the export gateways in the south so as to minimize time and cost. Prospects for this in the Pakistani context lie in efficient road and rail services and strategically located cargo consolidation facilities.

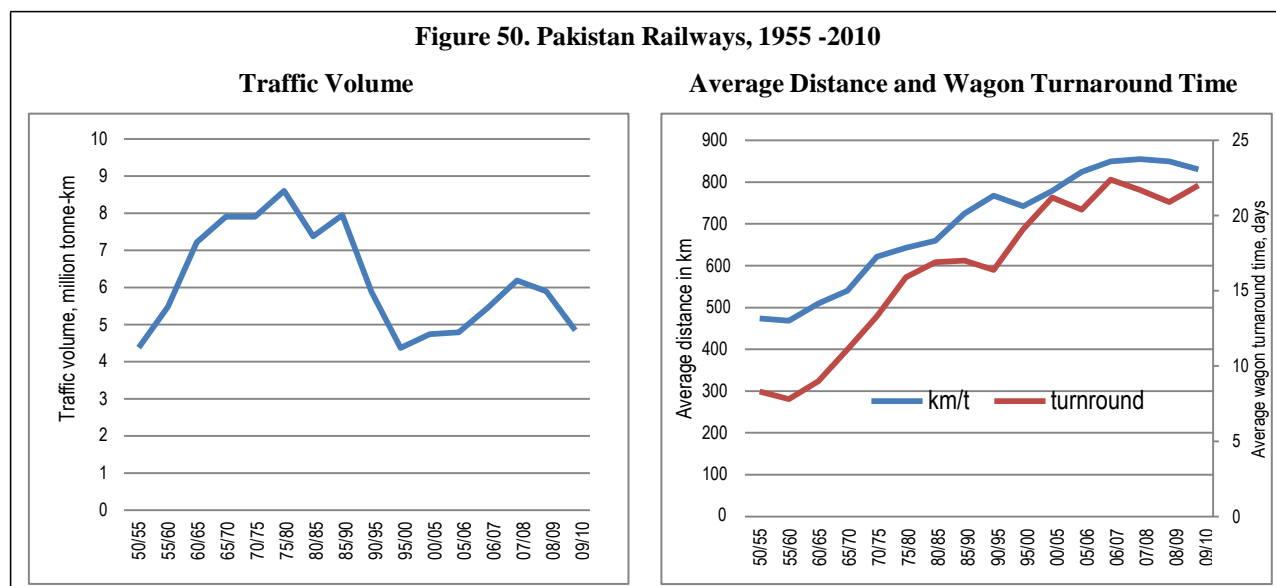
Figure 49. Pakistan Mango Exports, 1980 - 2008



5. Railways

285. The immediate challenge is that presently Pakistan Railways plays a relatively limited role in the country's freight transport despite having a network that extends over much of the country. Pakistan Railways has almost 8,000 kilometers of broad gauge routes linking all the major centers, and also interconnects to the Iranian network. Although the railway market share continues to decline, there has been a leveling off in the volume of freight traffic. Because of commercial constraints, the railways move only fully loaded trains, meaning there are usually long gaps between train departures while waiting for sufficient volumes to accumulate. Presently, it has reached enough cargo volumes to justify daily movement between Karachi and Lahore and multiple movements per week for the other centers. Once loaded, railway offers a comparable transit time but lower cost as compared with road transport (Figure 50).

Figure 50. Pakistan Railways, 1955 -2010



286. Despite the downward trend in traffic carried by rail, there is evidence that Pakistan railways has been increasing the average length of haul meaning it has been moving towards distances where rail has a comparative advantage over road transport. The pricing policy of Railways is designed to make it attractive to different types of commodities, officially depending on their ability to bear the cost since Pakistan Railway rates are based on the principle of "what each type of traffic can bear". However, the downside of this approach is that the railways are perennially making losses and have to be subsidized by the government. As a result, the availability of rolling stock and general maintenance of the system has been deteriorating in recent years. The railways are therefore caught in a downward spiral of poor performance leading to low demand for services which exacerbates the problem.

287. However, even with the above problems, there are good prospects that the railways can play a growing role in the movement of containerized traffic. A Cargo Express Service introduced in 1974 is now running a daily service transporting general cargo from Karachi Bandar to Lahore and vice versa. This cargo express has been restructured with high capacity, high speed wagons along with terminal facilities to allow it to handle loads of up to 1,600 tons. A similar cargo express has been initiated between Faisalabad-Multan and Karachi Bandar and vice versa.

288. There are two areas which impact negatively on the railway's ability to grow traffic volumes. The first are delays in the ports of Karachi where a significant proportion of turnaround time is incurred. This will require that customs issue transit permits with minimal delays and only physically inspect cargo on rare occasions. Consignees and shipping lines would also have to provide early notification to the port and customs regarding the inland destination of the containers. The second area, and perhaps the most important for extending trade opportunities to new products, is in measures to consolidate the low volumes of traffic to justify regular services that are at the same time reliable. The railway strategy in this regard has been to establish a network of dry ports across the country.

6. Dry Ports

289. As part of railway strategy, Pakistan Railways has tried to increase its market share in containerized freight by utilizing railway lands and rail head facilities to establish dry ports (Table 24). Dry ports are valuable for consolidating and deconsolidating traffic and also for facilitating customs and other regulatory controls inland, away from sea ports. Pakistan Railways has already established a network of such facilities some on its own, others as joint ventures with private sector partners while others are purely by the private sector on its own. There is a renewed recognition in Pakistan and elsewhere that dry ports are critical to improving performance of logistics services.

Table 24. Dry Ports in Pakistan

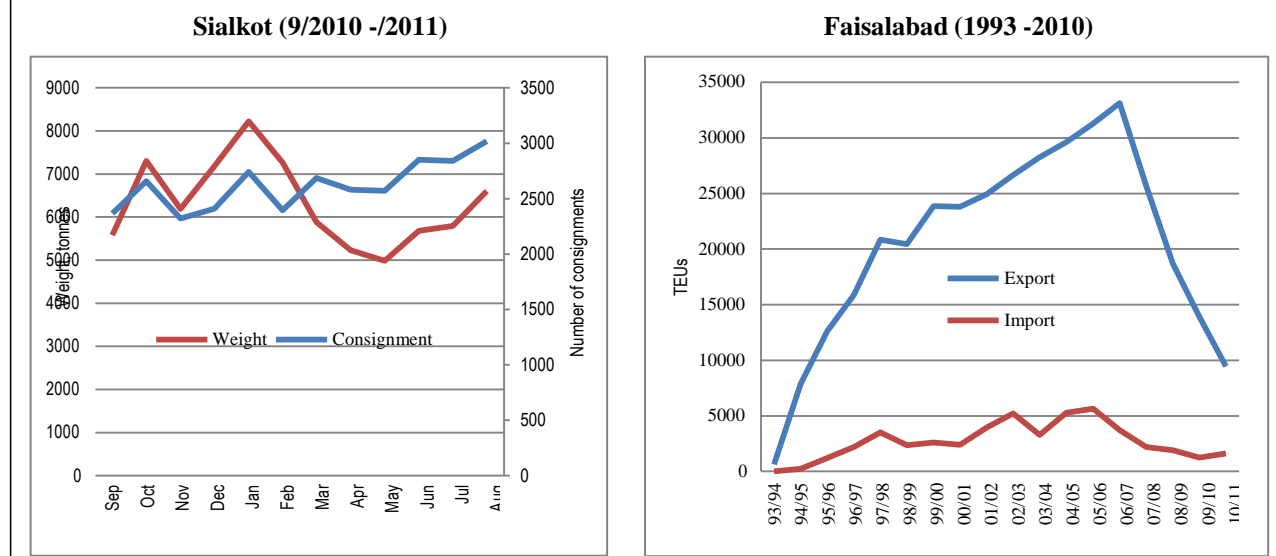
<i>Dry Port</i>	<i>Year of established</i>	<i>Distance to Karachi</i>	<i>Container Volume 2007/08</i>		<i>Container Volume, 2009/10</i>	
			Import	Export	Import	Export
Lahore	1973	1,268	7,589	5,609	9,819	4,541
Karachi	1974		8,120	6	17,089	6,112
Peshawar	1986	1,706	5,664	202	2,067	157
Faisalabad		1,179		1,827		158
KRK				2,429		2,056
Islamabad			5,100	126	4,724	159
Hyderabad		164				
Quetta	1984	675				
Multan	1988	934				
Rawalpindi	1990	1,546				
Sialkot	1986	1,406				

Note: NLC = National Logistics Cell.

290. Some of the above dry ports were developed by the private sector which has shown that that through innovation, manufacturing firms with common interests can invest in common facilities. For example, a dry port in Faisalabad which was developed by textile exporters or the airport and dry port in Sialkot, developed by sports goods and surgical equipment manufacturers. However, the key concern in industry is the cost and reliability of land transport connection to the air and sea transport services in Karachi. This has important implications on the success of the whole dry port initiative. There are few successful dry ports, due to poor services and limited local coordination, and for several, little or no traffic passes through.

291. Probably the most successful dry port initiative in Pakistan is the one in Sialkot. The dry port was established in the private sector in 1984 by 52 reputed exporters/businessmen of Sialkot. Each of them contributed a non returnable amount towards the cost of its establishment. The main aim of the facility is to provide the facility of Customs Clearance to the exporters and importers of this region at their door step. It has since developed its own fleet of customs bonded vehicles, with more than 70 vehicles providing services guaranteed in terms of transit time, safety and reliability. The dry port operation provides online tracking of consignments. Sialkot is therefore an example of the most sophisticated and efficient logistics operation in the country.

Figure 51. Cargo Volume Through Dry Ports, 1993 -2010



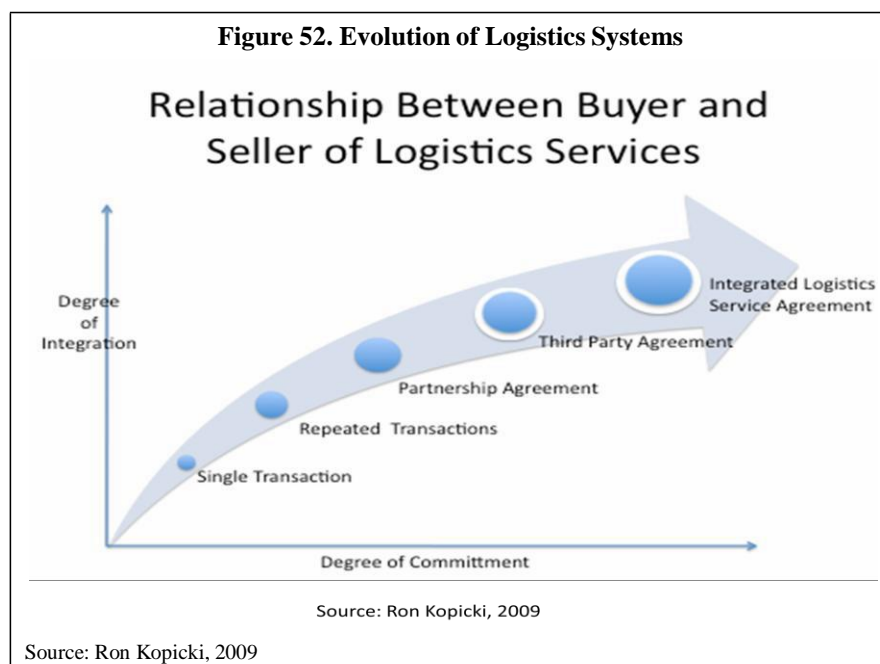
292. More than half of exports from Sialkot in August 2011 were by sea (meaning the cargo is moved to Karachi), while the remaining 43 percent was by air, in terms of number of consignments. In fact, in terms of weight 92 percent was by sea and 8 percent was by air transport. It means therefore that the cargo by sea is first transported to Karachi by land transport, typically road. Most shipments by air are transported by truck to Lahore and Islamabad while those by sea are transported by truck to Karachi and Port Qasim. Close to three quarters of air exports are through Islamabad, followed by Lahore airports, then Karachi and Peshawar. Peshawar is the fourth major airport. Most of the air consignments from Sialkot were transported by British Airways and Etihad. Therefore, even though PIA is the largest airline and has an extensive domestic air network, it is not widely used for international trade.

293. The above examples show the prospects of creating new opportunities for Pakistani trade through the strategic development of a network of dry ports. However, the dry ports have to be developed as multimodal facilities designed to handle specific trade traffic. A holistic total supply chain approach has to be adopted which combines value addition and logistics as part of a synchronized system. A contrast to Sialkot is the experience of another private sector dry port at Faisalabad (Figure 51). The latter has experienced a dramatic fall in traffic volumes due to the global financial crisis and due to concerns over security and reliability of Pakistani suppliers. As a result, there is more cargo handled through the Sialkot Dry Port in two months than at Faisalabad in a year.

7. *Upgrading Quality of Logistics Services*

294. As a country moves up the value chain, integrated logistics services become a key factor of competitiveness. They enable suppliers, and their customers to better integrate their systems to exploit market opportunities. Logistics services are a derived demand which in turn also open new opportunities to trade. Logistics services have to adapt to technological and economic changes. Technological changes that reduce the need for proximity between the producer and the consumer are also allowing the fragmentation of production into tasks performed in a vertically connected way

across different locations. The connection amongst tasks is enabled by advances in communication, logistics, and financial services among others (Figure 52).¹³⁴



295. In addition there are several operational imperatives to be considered in the pursuit of an improved global framework for logistics services. These forces are evident in Pakistan and add to the growing demands on the performance of the country's logistics system.

- Shared production networks
- Moving up value chains
- Greater competition in services to drive down costs
- Emerging demands, e.g. trade in new products, minimizing environmental impacts.

296. The coordination of trade facilitation and logistics in Pakistan is not easy, mainly due to institutional fragmentation and small scale enterprises participating in the profession. On the institutional side, each mode of transport falls under a different ministry: roads are under the Ministry of Communications, while there is also a Ministry of Railways, Ministry of Ports and Shipping and under Ministry of Defense which has a say on civil aviation matters. This multiplicity of public agencies makes it a challenge to coordinate actions and engender an integrated core logistics system.

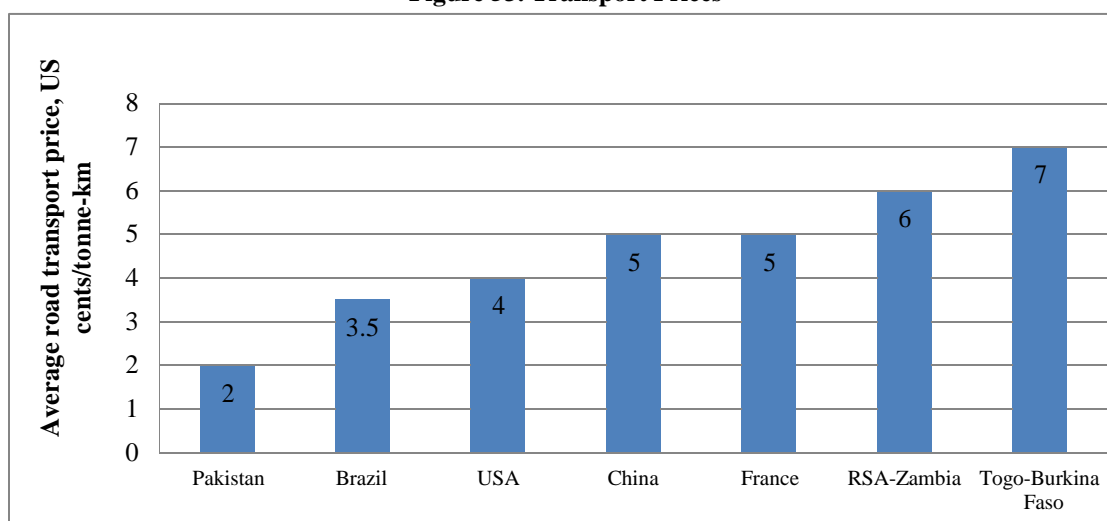
297. At the same time, the majority of Pakistan's logistics providers are small-scale enterprises offering a limited range of services and competing on cost with relatively little consideration for reliability or value. This has two significant consequences: services are generally of a poor quality and there is fragmentation in service delivery, involving numerous parties in the supply chain. The multiplicity of parties involved in transport and logistics services derives from, and is reflected in, disparate policy, institutional, and operational arrangements. Each mode of transport falls under a

¹³⁴ Feenstra, 1998 and Jones, 2000.

spate ministry while third party logistics services provision and ability to manage entire supply chains is still at a nascent stage, driven by a few local and international firms.

298. As a result, intermodal transport possibilities are not fully exploited, there is little investment in core facilities, and logistics services are generally unsuitable for open trade opportunities in new products and processes. The most important weaknesses in the quality of logistics services in Pakistan are faced in the trucking, freight forwarding and customs areas.

Figure 53. Transport Prices



8. *Trucking Industry*

299. Pakistan has the one of the lowest road freight transport rates in the world partly due to the structure of the industry. The majority of trucks on the roads are operated informally as small fleets. In 2007 there were as many as 209,000 registered trucks, more than two thirds of them rigid trucks, and most of them old and fuel inefficient. Until 2006, high import duties on imported trucks and requirements that only new trucks be imported was discouraging the renewal of the fleet.¹³⁵ As a result and as mentioned above, the trucking fleet is primarily older vehicles with inefficient engines and low power-to-weight ratios. As a result, the low rates are obtained by maintaining old fleets and by overloading the vehicles. Competition and high operating costs significantly reduce margins for the industry and hamper efforts to modernize the fleet.

300. Of the larger formal operations have recently started, the largest fleet operator is the state controlled National Logistics Cell (NLC) which owns more than 1,500 trucks. The NLC has previously had a monopoly on Afghanistan transit traffic. In addition to the NLC, the other large fleet operators are the petroleum companies such as Shell and the dry port operators especially Sialkot and Faisalabad. Sialkot operates more than 70 trucks. These larger operators all provide modern services including tracking of vehicles and shipments.

¹³⁵ In 2006, the GOP reduced and rationalized duties on prime movers. Also trucking was recognized as an industry allowing better access to finance. This allowed the importation of used trucks up to four years old that were compliant with EURO III standards.

301. At the same time, there has been some improved organization of independent truckers due in part to the demand of the military for increased services along with demand from larger multinationals for better quality road transport. Previously, individual shipments were contracted with rates negotiated directly with the shippers or their brokers while backhaul shipments were obtained from the large number of brokers located in the major cities. Now, some larger road haulage companies have supplemented their own fleet through regular contracting relationships with independent truck operators. Through this arrangement, performance criteria in the service, quality and reliability of the vehicles, and the skills of the drivers and route are being improved. Demand of this type is growing and is being extended to the larger domestic shippers, while in parallel, there has been an increase in the number of transport companies providing specialized services such as haulage of liquid bulk and refrigerated cargo.

302. Vehicle overloading has been a perennial characteristic of trucking in Pakistan for several decades. It is estimated that as many as 40 percent of trucks on Pakistan's roads are overloaded which has contributed to the rapid deterioration of the roads. In response, consideration is underway for a strict vehicle overload control regime especially on the national highway network which carries most of the heavy traffic and where recently weighbridges have been introduced.

303. The 2007 Trucking Policy was designed to complement the NCTIP and serve as the basis for modernizing the trucking sector. It contains several progressive provisions which, if realized would contribute to a higher quality of service from the trucking sector. Some of the key provisions of the policy are:

- Access to Finance: The policy seeks to designate the sector as an "industry" which allows for borrowing from banks at less than commercial rates.
- Motor vehicle registration: As motor vehicles registration is a provincial matter, it is difficult to obtain current information on the vehicle fleet. A central depository for motor vehicles for nationwide maintenance of data is proposed.
- Vehicle worthiness testing and certification: the policy provides regular certification for vehicle fitness and road worthiness. This will be accompanied by training and capacity building of staff involved in the tests.
- Other measures: Driver licensing, provision of rest areas and stops for trucks, improved standards for the manufacture and registration of trucks.

9. *Freight Forwarding Services*

304. Given the presence of numerous small players in the logistics market in Pakistan, a solid legal framework for the responsibilities and liabilities, including those of truckers, is paramount. However, this has been a significant gap in the legal framework in the country especially where it concerns liability for the goods as they move along the chain. Truck operators for instance only carry third-party liability. This is one of the reasons why the quality of freight forwarding is critical. Freight forwarders, most of who also serve as clearing agents, are the most important intermediary in trade logistics in any country.

305. There are reportedly more than 450 registered clearing and forwarding agents in Pakistan, employing about 12,000 people. The majority of the agents are not surprisingly based in the major logistics centers of Karachi, Lahore and Sialkot (Table 25). Most offer only limited services, such

that several role players have to be engaged to complete a whole import or export process. There are a few large and some international companies that also operate in the market and who offer more comprehensive services (these number about 50 out of the total). The large players account for most of the revenue in the sector. The majority of the agents are members of the Pakistan International Freight Forwarders Association (PIFFA).

Table 25. Distribution of Forwarding Agents in Pakistan, 2011

	Karachi	Lahore	Sialkot	Other
Small (primary only)	253	18	1.0	None
Medium	153	35	2.5	Moderate
Total Service	50	47	4.0	High
TOTAL	456		2.9	

Source: International Asset Management Company Limited, 2005.

306. The freight forwarding industry in Pakistan experienced strong growth in the 1990s. Much of this growth reflected the growing importance of the role of 'Integrated Logistics' service providers in international trade, increased use of containerization and the overall growth in Pakistan's international trade during that period. However, more recently this growth has slowed as trade has also slowed. Still, given the numbers involved, and similar to the trucking sector, the industry has a competitive market structure (Table 26). The intensity of competition is fierce at the primary services level and moderate for firms positioned higher upon the value chain.

Table 26. Market Share of Forwarding Agents, by Size

Small (primary only)	253	18	1.0	None	High
Medium	153	35	2.5	Moderate	High
Total Service	50	47	4.0	High	Moderate
TOTAL	456		2.9		

Source: International Asset Management Company Limited, 2005.

307. The forwarding industry has therefore undergone significant changes in terms of increases in scale and scope. Part of this is due to the increased presence of foreign third part logistics services providers who have extended their involvement in the sector from acting as nominated forwarders to providers of warehousing, inventory management and distribution services. This, in turn, has allowed large-scale retailers to enter the market. The evolution of agents from customs brokers to providers of warehousing and transport services is continuing as larger manufactures and shippers seek out integrated service providers. Increasingly, there is a degree of specialization that is going on as the large forwarders are avoiding taking on responsibility for owning and managing large truck fleets, but increasingly work with established road transport companies to provide services to their clients. In fact in some cases, they offer transport brokerage services.

308. One of the aspects often mentioned as a source of concern in the sector is the issuing of house bills of lading. These are based on archaic legislation especially, a maritime shipping act promulgated in the late 1800s (The Carriers Act, 1865). While many of the larger freight forwarders are able to issue House Bills of Lading for international movements of freight, there continue to be problems with regards to the allocation of liabilities among the parties involved in international shipments, especially the small scale players. Pakistan presently does not have legislation covering

multimodal transport, making for a weak framework for the enforcement of arbitration related to international shipments. There have been efforts over the past several years to upgrade legislation to clarify these liabilities but it is taking a long time to bring to fruition.

309. As some of the larger players attempt to offer superior services, they find the image of the industry as a whole is tarnished by the more informal small scale agents. Many of the issues which impact on the effectiveness of the freight forwarding industry are the same as those faced elsewhere in international trade:

- Unregulated market entry - easy access to the industry has resulted in many new entrants with increasing pressure on operators to be more competitive, perhaps at the expense of quality of service.
- A lack of technical expertise - there is minimal access to accredited training for industry participants and no minimum technical experience requirements.
- No nationally endorsed standard trading conditions and minimum standards which has resulted in disputes and a lack of confidence by some traders.
- Lack of access to commercial finance which has restricted development/expansion opportunities for industry participants (to help cover overheads and growth of trade receivables which result in cash flow issues).
- Legislative framework - Pakistan needs an updated legal framework to reflect the requirements of the contemporary international trade environment. Several of the laws date back several decades.

310. These challenges are very similar to those faced in other developing regions of the world. Elsewhere, the response has been to pursue skills development in the sector, typically with support from international associations such as FIATA. Other measures include also defining minimum requirements to be recognized as a service provider. However, solutions need always to be shaped by local circumstances.

311. The large freight forwarding firms in particular, are pushing for a regulatory approach to setting minimum service obligations. Evidence from elsewhere suggests that logistics is a bundle of services industries. This implies that in contrast to other services, logistics services providers are subject to multiple regulations and must deal with a larger numbers of regulators with different regulatory objectives and cultures. Moreover, regulating on a component basis makes it difficult to develop an optimal regulatory regime. In an ideal world, logistics services providers would be subject to a single authorization requirement and a single regulator, but this may prove not to be feasible or even desirable. There are a number of complex issues that justify regulations in this area such as competition, administration of port and airport physical space, safety, smuggling, and last but not least national security considerations, including terrorism threat. A way to address these complexities is to create a high level unit with the required political support to coordinate these agencies as was done recently by Indonesia and Uruguay, and other countries. This is what has been proposed in Pakistan through a draft Logistics Services Providers Regulatory Bill that is being discussed.

312. However as expected, there is no consensus as some industry players feel this will increase the regulatory burden while others feel the effort seeks to impose entry barriers to the sector. The

draft bill proposes the establishment of a Logistics Service Providers Regulatory Authority which is mandated to promote a modern system of logistics services in Pakistan. Among things the authority shall:

- advise the Government on policy relating to logistics services
- coordinate with all government systems for efficient functioning of logistics services
- prescribe, regulate or implement measures and standards for licensing or any matter related to logistics services
- ensure that all logistics service providers take suitable insurance cover for the cargo handled and transported by them
- evolve a mechanism for payment of compensation to aggrieved party for the cargo damaged or lost by it
- resolve disputes between service providers and service receivers
- promote education and research in the field of logistics services
- liaise and interact with counterpart logistics services related organizations in other countries for capacity building and exchange of information.

313. The powers of the authority would be such that it would assist in the development of the industry and help facilitate the growth of international trade. The proposed regulation would therefore be fairly comprehensive when compared to systems in other countries. Clearly the regulatory approach proposed could help provide a predictable and reliable logistics services framework for the industry in Pakistan as it appears from vigorous debate in the country even on the content of the draft that an environment does not exist yet for self-regulation as adopted in other countries, e.g. Canada, Malaysia, Singapore, South Africa, and the UK.

314. While it is not uncommon for governments to regulate such activities in some form or another, it is usually in the context of licensing or certification to ensure technical competence and business registration to ensure compliance with the civil or commercial codes (UNCTAD, 2011). The most common form of regulation in relation to freight forwarders focuses on defining contractual liability, generally based on FIATA and ICC rules to provide certainty for the banking sector. Such regulations are partially addressed in Pakistan through SBP circulars. In many instances governments have also tried to regulate the issuing of shipping documents (terms and conditions for the contract of carriage of goods). The intention of such amendments would be to try to bring Pakistan's COGSA more in-line with the international transport law framework provided under the Hague-Visby or Hamburg Rules.

315. At a broader level, given the high level of fragmentation in international supply chains in Pakistan, a lot of attention has been paid to strengthening the foundations for the use of contracts in organizing logistics services. For individual movements, the cargo documents used as the basis of agreement between the shippers or buyers and third party service providers largely depends on the mode of transport. For international trade there are a variety of conventions that specify the allocation of responsibilities and liabilities. These have been used for the past 10 years in Pakistan to try and modernize the legal frameworks for core transport services. The efforts have been promoted

by the NTTFC. They follow a realization that the core legislation on transport services are all dated, some time going back to the late nineteenth century.

10. Customs System

316. Clearly the practices and levels of skill of freight forwarders and other logistics players need upgrading. The draft bill seeks to address the former but it has to be complemented by capacity building measures if it is to have a meaningful impact. The main program on capacity building is the one offered by UNCTAD and FIATA. The two have been working with PIFFA to offer a validated course conducted by the National Industry Association. This is an important component to raise skills and the quality of services offered. In fact, PIFFA has established a significant training course to increase the skills of logistics service providers in general while other efforts are underway to establish a procedure for certification of freight forwarders.

317. However, there are also some clear operational issues that can also impact the overall performance of the trade logistics system in Pakistan. One of these is with respect to how agents interface with ports and customs. In particular, the electronic submission and processing of customs documents is critical to improved performance.

318. Pakistan Customs has been implementing a modernization program for the past several years. Reforms already introduced include the use of the Harmonized Code, creation of a Single Administrative Document (Goods Declaration (GD)), and electronic submission and processing of declarations at the seaports and the major land borders. These improvements have allowed a significant reduction in clearance times and an increase in the collection of duties and taxes. However, at present there are two different IT systems for submitting the goods declaration, Pakistan Customs Computerized System (PaCCS) and Web Based One Customs.¹³⁶ The rate of physical inspections has been reduced but remains higher than would apply with an effective system of risk management. More important, the decision regarding inspections is often based on informal payments. The typical clearance times for cargoes with proper documentation are two days for imports and one for exports. The procedures for handling transit cargoes have been simplified but the time required for issuing transit permits and the procedures regarding inspection of transit cargo are neither transparent nor efficient. Pakistan Customs has a Risk Management Unit which has developed some risk profiles and is supposed to select the level of inspection applied for individual shipments. However, both PaCCS and One Customs perform limited functions¹³⁷ and neither has a risk management module (PaCCS system uses random selection of containers). Still, the random selection can be overridden by an officer thereby creating significant opportunities for informal payments.

319. Clearly, it would be beneficial from a trade logistics perspective if a unified and comprehensive system was introduced and operational across the country. Customs are now working towards this, by adopting Web Based One Customs (WeBOC). This should enable the private sector to develop and invest in appropriate interfaces to the system. Presently this is difficult and inefficient as there are duplications. Critical aspects that are still lacking are introducing an effective risk management system, a formal Authorized Economic Operator (AEO) regime, and an expedited

¹³⁶ PaCCS has been used in the Karachi International Container Terminal (KICT) since 2005 and at two other container terminals since December 2006. It is reported after its introduction customs clearance times were reduced from seven days to less than one day in KICT.

¹³⁷ Both lack modules for valuation, risk management, transit/transshipment and warehousing, post clearance audit, temporary importation and duty drawback.

regime for transit shipments. These will allow more cargo to be cleared inland thereby reducing bottlenecks at the seaports and land borders and increasing the effectiveness of the clearance procedures and allowing for greater cooperation between shippers and customs officials. Presently, Pakistan does not have a formal system of AEOs, although informal recognition is given to preferred traders who receive expedited clearance. Modern X-ray scanning has been introduced but only at QICT and only for exports to the US as part of the C-TPAT program.

11. Measuring Overall Logistics Performance

320. Due to the institutional fragmentation discussed above, there is presently no agency that is systematically collecting performance metrics at either corridor level or at a macro level. Different agencies are collecting some data on trade facilitation and logistics performance though these data are not put together to inform reform to improve performance. That said, Pakistan has the basic ingredients for a well articulated and informative logistics performance monitoring platform, which industry can use to assess competitiveness. Over the past decade some steps have been taken to overcome the coordination weakness by creating a national trade facilitation committee, with the support of UNCTAD and the World Bank.

12. Regional Connectivity

321. One of the overriding objectives of the GOP is to develop the country as a regional hub for logistics. In this regard, the gateway for services via air and sea transport is well established, largely through Karachi. What remains largely poorly developed has been the land transport links to Pakistan's neighbors. This will have to be by land transport (road and rail) and also air transport. The limited potential, at least in the short term for air transport has already been alluded to. Basing land transport connectivity has great potential, but would require also changing the approach in the country, from being a transit country for landlocked Afghanistan to also itself relying on transit rights through the same country for access to the Central Asian Republics (CAR) in particular. Exploiting this potential requires that Pakistan take certain steps especially with respect to ratifying key international conventions and other regional trade facilitation instruments.

13. Transport and Transit Agreements

322. Pakistan has already been working for some time on negotiating transport agreements with several of its neighbors to the north and west. The highest priority of these agreements has been the one with Afghanistan, whose revised version entered into force in mid-2011. Others are being negotiated with the CAR. These are discussed separately below.

323. The most significant land transport and transit agreement Pakistan has is with Afghanistan. The Afghanistan-Pakistan Trade and Transport Agreement (APTTA) is the most important international agreement Pakistan has with its immediate neighbors. APTA replaces a previous agreement of 1965 showing that an agreement between the parties has always been important, especially for landlocked Afghanistan. The Karachi-Peshawar/Torkham as well as the Karachi-Quetta-Chaman/Spin Baldak corridors have traditionally been in use for the movement of goods to and from Afghanistan even before Pakistan's independence in 1947. An alternative route of lesser importance, during the British period, was the caravan route from the Gulf through Persia passing through Herat and beyond. Since the independence of Pakistan, the transit trade to Afghanistan continued to move on the two historical routes, while the first formal agreement was signed in 1958 between the two governments.

324. Up until 2010 Pakistan offered transit facilities to Afghanistan under the Afghan Transit Trade Agreement (ATTA) of 1965. However, ATTA was subject to the vagaries of change in the political and economic scenarios prevailing within the two countries. The original agreement provided for liberalized transit trade facilitation between the two. However, the agreement between the two has often been clouded by accusations often made that the transit facilities were often misused and a number of items to Afghanistan were smuggled back into Pakistan with negative effects on local industry and revenue collection in Pakistan.

325. Initially, Pakistan tried to curb re-export of transit goods into its territory through various measures including the delegation of anti-smuggling powers to the Frontier Corps and Political Authorities and the establishment of various combined check posts at Pakistan-Afghanistan border, and reducing the rates of duty in order to minimize the margin between costs of smuggling and cost of legal imports of these items. The efforts also included Pakistan adopting a negative list of 17 items, transit of which was prohibited through Pakistan's borders. Over time the negative list was first expanded to 24 items in 2001 though later reduced first to six items in 2004 and then by two items (cigarettes and auto parts) in 2006. The anti smuggling powers delegated to Frontier Corps, Frontier Constabulary and the Police were later on also withdrawn and at present only Customs, Customs Intelligence and the Political administration enjoy anti smuggling powers under the Pakistan Customs Act, 1969. In fact, with the mutual concurrence of both governments the existing ATTA, with minor amendments from time to time, governed the movement of Afghan goods through Pakistan for 44 years until the new agreement was signed in 2010.

326. The new agreement, APTTA was signed in July 2010 and entered into force in early 2011 and replaced ATTA. It is designed to be in force for five years, renewable for another five years after which it can be extended based on agreement between the two parties. The agreement is expected to halve the amount of time it takes to process transit traffic between Afghanistan and Pakistan. APTTA makes several very important changes with operational impact. However, two issues are worth highlighting in terms of likely impact on costs. First, APTTA increases the number of routes that can be used for transit and trade between the two countries from 5 to 10 in Pakistan and 8 in Afghanistan. It therefore provides for greater flexibility in the routing of transit traffic passing through the Pakistani ports of Gwadar, Qasim and Karachi as well as the transportation of bilateral trade traffic between the two countries. Second, a breakup up of the monopoly of the Pakistani transport company, NLC, from being the sole authorized carrier of Afghan transit cargo could bring significant benefits. NLC, though large, is expensive and often had no trucks available.¹³⁸ Under the new agreement, Afghan merchants are allowed to contract any transport company for the transit of goods to Afghanistan. This should result in lower transit costs as well as a more stable supply of consumer goods to Afghanistan.

327. One of the issues the agreement has tried to deal with is to provide a framework for systems to facilitate customs handling of goods in transit. The agreement provides for the countries to develop tracking systems and customs guarantees for such goods. Customs will also share information between them, to facilitate faster clearance of goods. Generally, under the agreement customs will physically check only five percent of Afghan transit cargo passing through the ports. There are however concerns in some quarters in Pakistan that some goods may still be diverted to the local market. Some of the above provisions are intended to manage such practices.

¹³⁸ A USAID study suggests it can take as long as 2 weeks for NLC to make vehicles available.

328. Though the agreement is progressive and a major departure from the previous one, it has one major restriction with respect to India. The agreement allows for Afghanistan transport operations to the Indian border where cargo can be offloaded to Indian trucks. However, Afghan trucks may not carry Indian goods in the reverse direction but are allowed to pickup Indian cargo.

329. The designation of transit routes under APTTA provides a base for wider regional trade and transport connections. Through the routes defined in Afghanistan it becomes possible for Pakistan to link to Azerbaijan, the CAR, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan. As discussed below, Pakistan is already negotiating bilateral road transport agreements with these countries to effect transit and transport operations with them. Already a road caravan has been conducted to test the route while Pakistan railways has run experimental trains to Turkey, with interchange at Iran border due to different gauges. These services could greatly open up new possibilities to trade especially with neighboring countries and beyond.

14. International Transit Regime

330. The need to have access to the seaports by the CAR along with trade policies and harmonized agreements to reduce time and costs is now recognized as a pre-requisite for future regional growth and development. Their access to sea ports would be through Afghanistan and then to Iranian or Pakistani ports. The shortest route for most destinations is to the ports in Pakistan. The reverse is also true that as Pakistan seeks improved access to the CARs then it needs to have an effective customs regime that facilitates hassle free transit. Both the public and private sectors in Pakistan see great potential to expand intra-regional trade and for Pakistan to serve as a regional logistics hub for CAR. A proven transit framework is the *Transports internationaux par la route* Convention (TIR).

331. TIR is a system of bonds, operated in nearly 70 countries, that guarantees that any customs and other duties will be paid on goods transported in transit trucks. Its objective is both the improvement of transport conditions and the simplification and harmonization of administrative formalities in international transport, particularly at frontiers. The TIR has three important principles: (i) goods carried under the TIR procedures in sealed road vehicles are not as a general rule submitted to examination in Customs offices *en route* (but they may be inspected when an irregularity is suspected). Customs authorities do not require vehicles to be escorted at carrier's expense on the territory of their country; (ii) the contracting parties authorize agreed professional associations to issue TIR carnets. These associations guarantee that they will pay the import or export duties and taxes, including penalty interest in case of irregularities. For the purpose of identification of the goods on which duties have to be paid, details of these goods are entered in the TIR carnet. Customs authorities discharge TIR carnets after conclusion of the transport operation. Discharge is equivalent to clearance and Customs authorities cannot claim taxes and dues after discharge; and (iii) irregularities render the offender liable to the penalties of the country where the offence was committed. In case of doubt, the offence is deemed to have been committed in the country where it was detected. Any person guilty of irregularities may be in future excluded from the operation of the Convention.

332. Pakistan has been working on acceding to the TIR Convention for almost the past eight years. ICC Pakistan had been designated as the National Guaranteeing Organization for ATA Carnet and TIR Carnet system. However, progress has stalled over Pakistan's attempt to have reservations on some provisions of the TIR convention, for which reservation is not allowed. Initially a reservation was sought based on Article 58(i) of the TIR Convention, a request which was turned down by the United Nations. Later an attempt was made to seek a reservation, later dropped on Articles 57(1) to

57(6) of the convention. Clearly, acceding to the convention seems to be contentious in the country and an official decision has been made to suspend the efforts until there is consensus. It remains true though that operationalizing the road transport agreements being negotiated with the CARs will depend on accession to the TIR Convention as an effective transit transport. In any event, the TIR would also greatly benefit transit trade with Afghanistan as it can be an instrument to address concerns over likely diversion of goods in transit into the Pakistani domestic market.

Table 27. Major International Trade Facilitation Instruments

X = Ratification, accession, definite signature, O = Observer governments

CHAPTER V. MARKET ACCESS AND PREFERENTIAL TRADE AGREEMENTS

334. Following global trends, Pakistan is pursuing a strategy of economic integration through preferential trade agreements. Until 2006, Pakistan was member of multilateral preferential trade agreements only but has since been pursuing a policy of regional and bilateral trade integration, including SAFTA and bilateral agreements with China, Iran, Malaysia, Mauritius and Sri Lanka (Table 28). This shift reflects awareness in Pakistan that the country under trades with the large and fast growing economies from the region, including China and India.

Table 28. List of Pakistan's Multilateral and Preferential Trade Agreements

Agreement	Current Partners	Entry into force	Type of agreement	Main provisions	Exports, 2010 (% share tot.)	Imports, 2010 (% share tot.)
Multilateral agreements:						
Protocol on Trade Negotiations	Bangladesh; Brazil; Chile; Egypt; Israel; Korea, Republic of; Mexico; Pakistan; Paraguay; Peru; Philippines; Serbia; Tunisia; Turkey; Uruguay	1973	Partial Scope Agreement	-	11.44	4.54
WTO	153 WTO Members	1995	Multilateral	-	88.30	96.16
Preferential agreements:						
Economic Cooperation Organisation	Afghanistan; Azerbaijan; Iran, Islamic Republic of; Kazakhstan; Kyrgyz Republic; Pakistan; Tajikistan; Turkey; Turkmenistan; Uzbekistan	1992	Partial Scope Agreement	Cooperation on projects and programmes of mutual interest	11.95	3.39
GSTP	Algeria; Argentina; Bangladesh; Benin; Bolivarian Republic of Venezuela; Bolivia, Plurinational State of; Brazil; Cameroon; Chile; Colombia; Cuba; Ecuador; Egypt; Former Yugoslav Republic of Macedonia; Ghana; Guinea; Guyana; India; Indonesia; Iran, Islamic Republic of; Iraq; Korea, Democratic People's Republic of; Korea, Republic of; Libyan Arab Jamahiriya; Malaysia; Mexico; Morocco; Mozambique; Myanmar; Nicaragua; Nigeria; Peru; Philippines; Singapore; Sri Lanka; Sudan; Tanzania; Thailand; Trinidad and Tobago; Tunisia; Viet Nam; Zimbabwe	1989	Partial Scope Agreement	Tariff concessions	16.10	24.02
Pakistan-Sri Lanka	Sri Lanka	2005	PTA	Tariff concessions	1.35	0.14
South Asian Free Trade Agreement	Bangladesh; Bhutan; India; Maldives; Nepal; Pakistan; Sri Lanka	2006	PTA	Tariff concessions	5.69	4.50
Pakistan-Iran	Iran	2006	PTA	Tariff concessions	0.86	2.36
Pakistan-China	China	2007	PTA	Preferential market access through tariff concessions and mutual recognition arrangements in the field of services	6.55	13.99
Pakistan-Mauritius	Mauritius	2007	PTA	Tariff concessions limited to textiles sector	0.16	0.00
Pakistan-Malaysia	Malaysia	2008 (and 2005)	PTA (and Early Harvest Programme)	Tariff concessions in goods and services + market access provisions. Mutual recognition arrangements in the field of education and services and chapter on investment.	0.67	5.48
Pakistan-Afghanistan	Afghanistan	2010	Transit Trade Agreement	Provisions for the facilitation of merchandise transit.	7.95	0.37

Source: WTO and Government of Pakistan, Ministry of Commerce; WITS.

A. Trade Preferences and Pakistan's Trade

335. Pakistan's trade is not very preferential on the imports side, but much more preferential on the exports side. Fewer than 42 percent of Pakistan's imports receive any preferences but 84 percent of Pakistan's exports go to countries granting preferences to Pakistan, where preferential tariff margins are quite low (Table 29). Only 0.3 percent of exports to the top 20 importers receive a preference margin of 10 percent or above, mainly in the sectors of garments and commodities, while 30 percent have a preference margin between 0.1 and 2.5 percent.

Table 29. Partners In Pakistan's Trade, 2003 - 2010

Pakistan Exports (% total)								
	2003	2004	2005	2006	2007	2008	2009	2010
United States	23.2	24.0	24.9	25.8	22.3	18.2	18.4	17.3
China	2.2	2.3	2.7	3.0	3.5	3.6	5.7	6.5
India	0.7	1.2	2.1	1.9	1.7	1.8	1.3	1.3
Malaysia	0.8	0.5	0.4	0.4	0.4	0.7	0.9	0.7
SAFTA (exc. India)	2.2	2.6	2.5	2.7	2.8	3.2	3.4	4.4
EU-27	29.6	31.1	27.0	27.0	27.8	26.4	25.6	24.9
GCC	14.8	12.0	11.1	10.4	13.5	15.6	13.5	12.3
Trade under FTAs	0.0	0.0	0.0	5.7	5.6	7.3	12.9	13.9

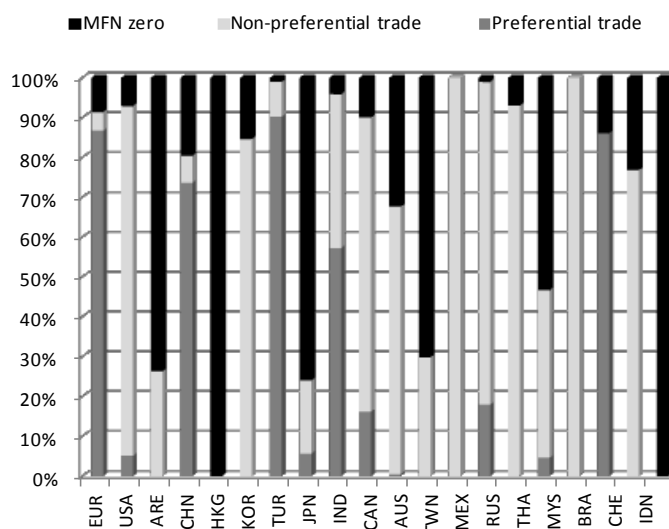
Pakistan Imports (% total)								
	2003	2004	2005	2006	2007	2008	2009	2010
China	7.3	8.3	9.3	9.8	12.8	11.2	12.0	14.0
Malaysia	4.6	3.5	2.9	2.6	3.6	4.0	5.1	5.5
United States	6.0	9.6	6.1	6.3	8.0	4.9	5.7	4.3
India	1.7	2.5	2.3	3.7	3.9	4.0	3.4	4.2
SAFTA (exc. India)	0.7	0.5	0.5	0.4	0.4	0.4	0.4	0.3
EU-27	17.0	14.1	17.6	16.6	14.6	13.6	16.1	11.4
GCC	29.3	28.6	27.1	30.8	28.3	33.6	29.2	32.8
Trade under FTAs	0.0	0.0	0.0	5.7	5.6	6.1	23.9	26.3

336. Table 30 provides an overview of the trade regime enjoyed by Pakistan in the largest 20 export markets while Figure 54 1 gives a graphical description of the share of Pakistan's exports to each of these markets enjoying preferential, non-preferential or MFN zero-tariff regime. These figures reflect more general trends. Only 16.7 percent of world trade is eligible for trade preferences, assuming full utilization of trade preferences (Carpenter and Lendle, 2010). In other words, despite the flourishing of preferential trade agreements in recent years, 83 percent of world merchandise trade still takes place on a non-discriminatory, MFN basis. This is firstly because half of world trade is already subject to zero-tariffs, on a most favored nation basis. Secondly, preferential trade agreements tend to exempt high MFN-tariff items from preferential treatment and continue to trade these products at the MFN rate (WTO, 2011). In addition, large preferences tend to fall on very elastic goods, further reducing the efficacy of preferences (Fugazza and Nicita, 2010). Low MFN rates suggest that the scope for exchanging preferential market access is unlikely to be extensive both for Pakistan and globally.

Table 30. Preferential Trade Regime For Exports to Top 20 Markets

Importer	Exporter	Regime	Reciprocal?
EUR	PAK	EU_GSP	no
USA	PAK	US_GSP	no
ARE	PAK	MFN	MFN
CHN	PAK	FTA_CHN	yes
HKG	PAK	MFN	MFN
KOR	PAK	PSA_KOR	yes
TUR	PAK	GSP_TUR	no
JPN	PAK	GSP_JPN	no
IND	PAK	FTA_IND	yes
CAN	PAK	GSP_CAN	no
AUS	PAK	GSP_AUS	no
TWN	PAK	MFN	MFN
MEX	PAK	MFN	MFN
RUS	PAK	PREF_RUS	yes
THA	PAK	MFN	MFN
MYS	PAK	PSA_MYS	yes
BRA	PAK	MFN	MFN
CHE	PAK	GSP_special_CHE	no
IDN	PAK	MFN	MFN
SGP	PAK	MFN	MFN

Figure 54. Pakistan's Preferential Exports
(percentage shares)



B. Welfare Effects of Tariff Liberalization in Pakistan

337. Trade liberalization enhances aggregate productivity and increases the variety of products available in the economy. Despite these benefits, countries are reluctant to open trade on the grounds that it is also seen as a source of revenue losses for countries. This section looks at the main economic and fiscal impacts of the implementation of Pakistan's most significant PTAs: China, Malaysia, and SAFTA (Bangladesh, Bhutan, India, Maldives, Nepal, and Sri Lanka). Simulations are based on the World Bank SMART (System of Market Analysis and Restrictions of Trade) - a partial equilibrium tool that is part of the World Bank-UNCTAD WITS (World Integrated Trade Solution) platform.

338. Specifically, based on tariff and trade data from 2009, one can simulate a tariff reduction to zero for all products between partners of PTA. Each scenarios is first run independently from the others and then as a simultaneous implementation of all PTAs. Finally, three additional scenarios are added, for benchmarking purposes: a stand-alone PTA with India (not including other SAFTA countries), and hypothetical PTAs with the EU-27 and US, respectively. An important caveat of SMART-based analysis is however that the simulation tool only allows taking into consideration first-round effects. Hence, it only account for currently traded products.

339. The increase in Pakistan's imports of currently trade products as a result of the implementation of a zero-tariff regime in the framework of currently signed PTAs is modest and ranges from 0.3 to 2.7 percent of total imports (Figure 55). The biggest impact would result from the full implementation of a zero-tariff regime under the PTA with China. Imports would increase by 2.7 percent with respect to the baseline (total imports in 2009). Slashing tariffs in the framework of PTAs with India and Malaysia would have a smaller effect, which is similar for the two agreements. In both cases, bilateral imports would increase by less than 0.5 percent. The impact of implementing full liberalization with all SAFTA countries would increase imports by 0.33 percent. India accounts for

94 percent of that increase. It is to be expected, however, that tariff reduction would also increase the product range of imported goods for which now barriers are prohibitive.

340. Turning to bilateral trade, while imports from partners in the PTAs would increase according to our simulations, imports from some East Asian countries, the EU-27 and the US would be affected somewhat negatively by the full tariff implementation in the framework of currently negotiated PTAs (Table 31). Imports from all partners in current PTAs would increase by double digits if those PTAs were to lead to full tariff liberalization. Meanwhile, the largest negative impact would be felt in the case of the PTA with China and Japan with 2.6 percent of loss in terms of imports value. Similarly, imports from a handful of other East Asian countries (Indonesia, Korea and Thailand) as well as those from the EU-27 and the US would be affected negatively by the implementation of the FTA with China. Imports from the rest of Pakistan's main trade partners would be marginally impacted (less than 0.5 percent), in particular by full tariff liberalization in the framework of the PTAs with India, Malaysia or SAFTA.

Figure 55. Change in Pakistan's Total Imports, 2009-2010

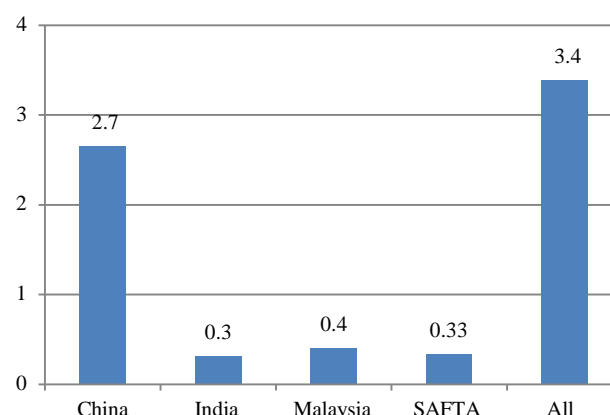
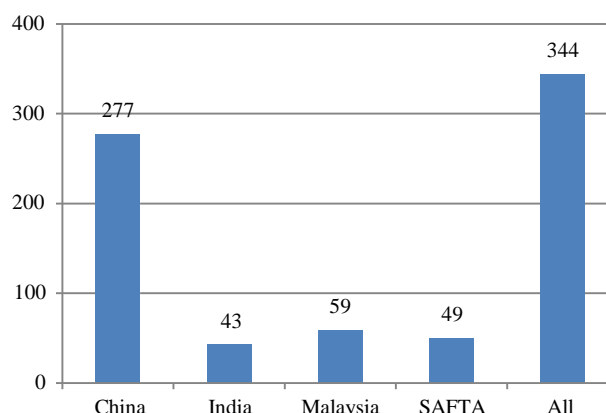


Table 31. Changes in Bilateral Imports from Main Partners as a Result of PTAs, 2009-2010

China	3,777	28.5	-0.3	-0.3	-0.3	28.0
Saudi Arabia	3,494	-0.1	-0.2	-0.1	-0.1	-0.3
UAE Kuwait	3,349	-0.3	-0.2	-0.1	-0.1	-0.7
United States	1,804	0.0	-0.3	0.0	-0.1	-0.4
Japan	1,760	-1.4	-0.1	-0.1	-0.1	-1.6
India	1,289	-2.6	-0.2	-0.1	-0.1	-3.0
Iran, Islamic Rep.	1,080	-1.0	-0.1	12.6	12.6	11.6
Korea, Rep.	955	-0.1	0.0	-0.4	-0.4	-0.5
Thailand	627	-2.5	-0.3	-0.4	-0.5	-3.4
Australia	600	-2.5	-0.7	-0.1	-0.2	-3.5
Indonesia	535	-0.2	0.0	0.0	0.0	-0.3
Malaysia	506	-1.6	-0.4	-0.2	-0.4	-2.4
Singapore	496	-2.0	36.2	-0.1	-0.2	34.2
Canada	492	-1.2	-0.2	-0.1	-0.1	-1.5
	403	-0.7	0.0	0.0	0.0	-0.7
EU-27	5,087	-1.8	-0.2	-0.2	-0.2	-2.2
Germany	1,270	-2.1	-0.2	-0.2	-0.2	-2.5
United Kingdom	780	-1.7	-0.1	-0.1	-0.1	-1.9
Italy	677	-2.1	-0.2	-0.2	-0.2	-2.5
Finland	418	-2.6	0.0	0.0	0.0	-2.7
France	396	-1.6	-0.1	-0.2	-0.2	-1.9

341. Trade diversion resulting from a zero-tariff PTA with China is significantly higher than under other scenarios, potentially leading to as much as US\$ 277 million of trade diversion. Although the trade diversion effect of a PTA with China is five times larger compared to the other PTAs analyzed, it would still only affect 0.9 percent of total imports of currently trade products (Figure 56).

Figure 56. Trade Diversion Under Different Scenarios
(US million)



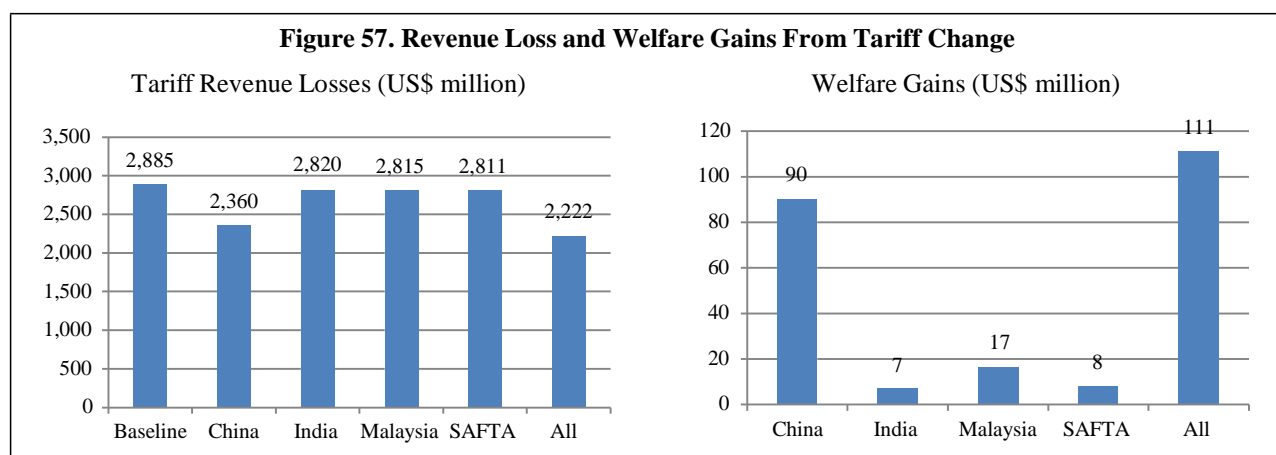
C. Fiscal impact and welfare gains

342. The fiscal impact of FTAs with India, Malaysia and SAFTA are low, and high with China, according to the simulations using SMART. Results are reported in Table 32. The fiscal impact of a zero-tariff PTA with Malaysia would be equal to about US\$ 70 million or 2.4 percent of tariff revenues in 2009. A PTA with India is about US\$ 65 million or 2.2 percent of tariff revenues in 2009. Signing an FTA with the rest of the SAFTA countries would result in an additional loss of revenue of US\$9 million or 0.2 percent of total imports, taking the total to US\$ 74 and 2.6 percent of revenues. The reduction of tariffs resulting from the implementation of a PTA with China would have by far the biggest impact on revenues and trade. Tariff revenue would go down by US\$ 525 million or 18.2 percent.

Table 32. Changes in Revenue and Welfare From PTA

China	-525	-18.2	90.3	8.3
Malaysia	-70	-2.4	16.7	13.7
India	-65	-2.2	7.3	13.7
SAFTA	-74	-2.6	8.2	13.6
All current PTAs	-663	-23.0	111.3	7.6

343. Including all the previous scenarios (China, Malaysia and SAFTA) as a free trade partner increases the total loss in tariff revenues by US\$ 663 million or 23 percent of tariff revenues. Figure 57 provides the welfare gain estimates net of the tariff revenue loss. While these are small compared to the tariff revenue losses, they are underestimated. Indeed they do not consider the associated increase in productivity, variety and quality of imported inputs. Hence, full tariff liberalization would generate a gain in welfare above the estimated figures, with the only cost of a shift away from tariffs in the composition of tax revenues.

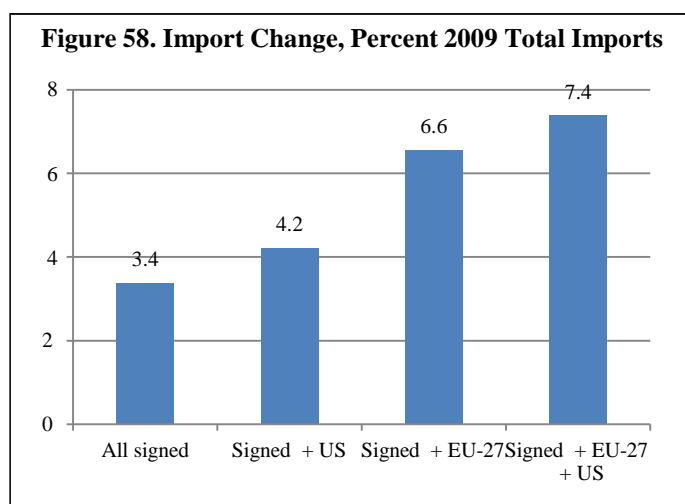


D. Effects of Full Tariff Liberalization on the Intensive Margin of Imports

344. The potential impact of implementing hypothetical zero-tariff PTAs with two of Pakistan's main trade partners, namely the EU-27 and the US is estimated along with two additional scenarios for comparison: (i) all currently signed PTAs (China, Malaysia, and SAFTA) would lead to full tariff liberalization, and (ii) simultaneous implementation of all PTAs (currently signed and hypothetical ones).

345. The implementation of a PTA with the EU-27 would have about the same impact on imports as the implementation of all previously signed PTAs by Pakistan. A PTA with the EU-27 would increase imports by an extra 3.2 percent over the 3.4 percent increase resulting from the implementation of the signed PTAs analyzed in the previous section—for a total import increase of 6.6 percent. The marginal increase of implementing a PTA with the US is lower and would further increase imports by 0.8 percent over the increase that result by implementing all signed PTAs (for a total increase of 4.2 percent) (Figure 58).

346. Imports from EU-27 and from the US would increase significantly with the implementation of a zero-tariff PTA while imports from Japan, Korea and Thailand would be significantly affected by the proposed PTAs.¹³⁹ However, if a PTA were to be signed with the US, imports from this destination would grow by 19.9 percent while imports from the EU-27 would decline by 3.2 percent. Conversely, if a PTA were to be signed with EU-27 but not with the US, imports from the former would increase by 21.8 percent while imports from the latter would decline by 4.9 percent (Table 33).



¹³⁹ If both hypothetical scenarios were implemented, imports from Japan (-6.8%), Korea (-7.0%) and Thailand (-5.9%) would be significantly affected while imports from the US (17.1%) and the EU-27 (20.8%) would grow by double digits.

Table 33. Changes in Bilateral Imports from Main Partners as a Result of PTAs

Partner	All signed PTAs	Proposed PTAs		
		All current + US	All current + EU-27	All current + US + EU-27
China	28.0	27.5	25.7	25.1
Saudi Arabia	-0.3	-0.3	-0.4	-0.5
UAE	-0.7	-0.8	-1.2	-1.5
Kuwait	-0.4	-0.4	-0.5	-0.5
United States	-1.6	19.9	-4.9	17.1
Japan	-3.0	-3.9	-5.8	-6.8
India	11.6	11.5	10.9	10.8
Iran, Islamic Rep.	-0.5	-0.6	-0.8	-0.9
Korea, Rep.	-3.4	-3.8	-6.4	-7.0
Thailand	-3.5	-3.9	-5.4	-5.9
Australia	-0.3	-0.5	-1.4	-1.7
Indonesia	-2.4	-2.6	-3.5	-3.8
Malaysia	34.2	33.8	32.8	32.3
Singapore	-1.5	-2.2	-3.7	-4.5
Canada	-0.7	-1.1	-2.1	-2.6
EU-27	-2.2	-3.2	21.8	20.8
Germany	-2.5	-3.6	24.1	23.1
United Kingdom	-1.9	-3.1	19.1	18.8
Italy	-2.5	-4.2	28.7	27.0
Finland	-2.7	-3.3	22.7	22.1
France	-1.9	-3.1	20.0	18.8

E. Fiscal Impact and Welfare Gains

347. The fiscal impact of signing a zero-tariff PTA with the EU-27 would be significant and added to the impact of already signed PTAs would result in a 41.7 percent loss of tariff revenue. The additional impact of implementing a PTA with the EU-27 is US\$ 541 million or 18.7 percent of tariff revenues in 2009. Adding the costs of already signed PTA would bring the total revenue impact to US\$ 1,204 million or 41.7 percent of revenues. The additional fiscal cost of adding a PTA with the US is significantly lower at US\$ 159 million or 5.5 percent of 2009 tariff revenues and a total impact (including signed PTAs) of US\$ 822 or 28.5 percent of tariff revenues. Figures 59 and 60 and Table 34 provide the welfare gain estimates net of the tariff revenue loss.

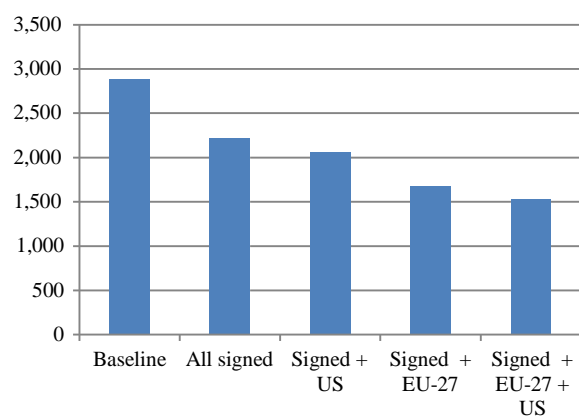
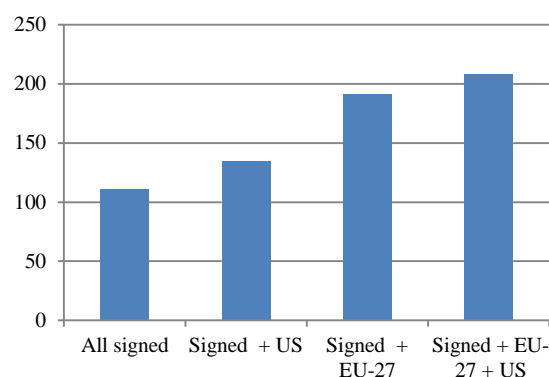
Figure 59. Tariff revenue losses (US\$ million)**Figure 60. Welfare gains (US\$ million)**

Table 34. Changes in Tariff Revenue and Welfare as a Result of Proposed FTAs

1. China	-525	-18.2	90.3	8.3
2. India	-65	-2.2	7.3	13.7
3. Malaysia	-70	-2.4	16.7	13.7
4. SAFTA	-74	-2.6	8.2	13.6
All signed (1+3+4)	-663	-23.0	111.3	7.6
All signed + US	-822	-28.5	134.7	6.5
All signed + EU-27	-1,204	-41.7	191.2	4.6
All signed + US + EU-27	-1,347	-46.7	207.7	3.7

F. Beyond Tariffs and Market Access

348. PTAs are not only about lowering tariffs and gaining better market access abroad. Focusing on tariffs and market access only is missing a lot of the action that takes place in preferential agreements (Chaffour and Maur, 2011). There are wider-ranging motivations for countries to engage in PTAs. These include the need to gain credibility, political motives and, increasingly, the willingness to signal openness to investors and to achieve deeper commitments in response to the emergence of supply-chain production as a prominent mode of twenty-first century economic integration. Global value chains have grown dramatically over the past two decades and are now responsible for a large share of global trade and an even larger share of trade within Asia. Traditional trade policy tools and trade agreements are based on a conceptual framework of producer to consumer trade where countries efforts were aimed at enhancing market access. By contrast, the demand from industry is increasingly more complex.

349. Indeed, ample evidence shows that the commitments in PTAs cover a large number of non-tariff policy areas and have become deeper over time. The WTO has recently compiled a dataset reviewing in detail the coverage and legal enforceability of all PTAs having been notified to the WTO (WTO, 2011). The identification of the policy areas and the definition of enforceability are based on Horn et al. (2010). The WTO analysis shows that commitments in services, investment, intellectual property protection, technical barriers to trade and competition policy loom large in PTAs (Table 35).

Table 35. Policy Areas Covered by PTAs

Shallower PTAs policy areas	Deeper PTAs policy areas	
FTA Industrial	Competition Policy	SME
FTA Agriculture	TRIPs	Economic Policy Dialogue
Customs	IPR	Statistics
AD	Movement of Capital	Human Rights
CVM	Investment	Political Dialogue
Export Taxes	Environmental Laws	Illicit Drugs
TBT	Research and Technology	Anti-Corruption
GATS	Agriculture	Data Protection
State Aid	Regional Cooperation	Audio Visual
STE	Education and Training	Illegal Immigration
Public Procurement	Labour Market Regulation	Money Laundering
SPS	Visa and Asylum	Health
TRIMs	Energy	Mining
	Industrial Cooperation	Taxation
	Cultural Cooperation	Public Administration
	Social Matters	Terrorism
	Consumer Protection	Nuclear Safety
	Approximation of Legislation	Innovation Policies
	Financial Assistance	Civil Protection
	Information Society	

350. Reflecting changes in underlying realities, also the content of the more recent bilateral trade agreements undersigned by Pakistan with China and Malaysia, respectively, goes beyond market access. Table 36 compares the different structure of provisions regulating Pakistan's PTA with SAFTA (a shallow agreement) and the agreement recently signed with China (the deepest of all of Pakistan's PTAs). While the bilateral agreement with SAFTA only deals with tariffs for agricultural and industrial goods, the agreement between Pakistan and China covers non-tariff measures, services and regulatory matters, including—among others—provisions regulating the mutual recognition of services suppliers and other technical barriers to trade, international property rights and the establishment of Chinese investment zones in Pakistan. The preferential trade agreement between Pakistan and Malaysia is also deep in nature, and includes investment provisions in the fields of computer and IT related services, Islamic Banking, Islamic Insurance and mutual recognition arrangements for accreditation of education institution and academic programs. All remaining PTAs listed in Table 36 are shallow in nature, i.e. they primarily cover issues of market access.

Table 36. Provisions in Pakistan's PTAs with SAFTA Partners and China

PTA	SAFTA		PAK-CHN	
	Provision	Legally enforceable?	Provision	Legally enforceable?
FTA Industrial	1	yes	1	yes
FTA Agriculture	1	yes	1	yes
Customs	1		1	yes
Export Taxes	0		1	yes
SPS	0		1	yes
TBT	1		1	yes
AD	0		1	
CVM	0		1	
State Aid	0		1	
IPR	0		1	yes
Investment	0		1	yes
Total	4	2	11	8

Source: WTO (2011)

351. Other tools have been increasingly used, globally and in Pakistan, which are complementary in coverage to PTAs in their role of creating a framework of trade and investment rules able to address the emergence of supply-chain production as a prominent mode of twenty-first century economic integration. These include bilateral investment treaties (BITs) and double taxation treaties (DTTs). Generally speaking, investment and trade are regulated by distinct treaties because they focus on different but complementary objectives (Di Mascio and Pawelyn, 2008). Trade agreements seek to increase trading opportunities and investment agreements seek to protect and promote foreign investment. BITs have been an important vehicle that capital abundant countries have used to guarantee investment protection (Adlung and Molinuevo, 2008) and that labor-abundant counterparts have used to attract off-shored manufacturing jobs and factories (Baldwin, 2010).

352. As of 2011, Pakistan had signed 47 such agreements (Table 37).¹⁴⁰ These are agreements that establish disciplines that govern interactions between private foreign investors and host governments. In the case of Pakistan, most of the bilateral investment agreements are aimed at avoiding double taxation and at facilitating trade and investment. While Pakistan's older bilateral investment agreements were with developed countries, the more recent agreements are increasingly South-South in nature. This parallels developments in trade in parts, which from North-North developed into North-South and now increasingly extent to South-South deals.

353. According to Bergstrand and Egger (2011), the likelihood that a country-pairs establishes BITs and PTAs is higher: the larger and the more similar in income level the two countries are and the closer geographically the two countries are. Nevertheless, while the likelihood of signing PTAs is higher if the country shares a border and a language, for BITs the opposite is true. Countries that do not share a border or a language are more likely to sign investment agreements. Finally BITs tend to be more frequent between skilled labor abundant countries.

Table 37. Pakistan Bilateral Investment Agreements

Pakistan BITs	Signature	Entry into force	Pakistan BITs	Signature	Entry into force
Germany	1959	1962	Denmark	1996	
Romania	1978	1978	Indonesia	1996	
Sweden	1981	1981	Syria	1996	
France	1983	1984	Tunisia	1996	
Kuwait	1983		Belarus	1997	
Korea,	1988	1990	Italy	1997	2001
Netherlands	1988	1989	Mauritius	1997	
China	1989	1990	Oman	1997	
Uzbekistan	1992		Sri Lanka	1997	
Spain	1994	1996	Australia	1998	1998
Turkmenistan	1994		Belgium-Luxembo	1998	
United Kingdom	1994	1994	Japan	1998	2002
Azerbaijan	1995		Czech Republic	1999	
Bangladesh	1995	1997	Philippines	1999	
Iran	1995	1998	Qatar	1999	
Kyrgyz Republic	1995		Egypt	2000	
Malaysia	1995		Bosnia and Herzeg	2001	
Portugal	1995	1996	Lebanon	2001	2003
Romania	1995	1996	Morocco	2001	
Singapore	1995		Kazakhstan	2003	
Switzerland	1995	1996	Cambodia	2004	
Turkey	1995	1997	Lao	2004	
United Arab emirat	1995		Tajikistan	2004	
source: http://icsid.worldbank.org/ICSID/FrontServlet					

¹⁴⁰ An alternative source of information on BITs is UNCTAD: <http://www.unctad.org/Templates/WebFlyer.asp?intItemID=3150&lang=1>.

G. Trade Creation and Diversion Effects of Pakistan's PTAs

354. Several studies have examined the impact of PTAs and tested the traditional theories of trade creation and trade diversion. While theoretical models identify a number of channels for trade creation, empirically, the effect may be different from agreement to agreement. As concerns trade diversion, theoretical models also identify a number of channels through which non-preferential trade partners can be harmed by PTAs. Empirically, the effect of trade diversion of existing PTAs worldwide has been estimated to be of second order importance (Freund and Ornelas, 2010). Notwithstanding the general results, it may be more relevant in some specific cases. Hence, in this section the effect of agreements undersigned by Pakistan to date is tested in terms of trade creation and diversion and their value is compared to the effect for PTAs worldwide. This is a more complete assessment of the effects of PTAs on trade than the one carried out earlier in the report by simulation analysis, in several respects: both trade creation and trade diversion are measured; effects on overall trade and separately for the intensive margin of trade are estimated; the evolution of trade and trade policy linkages among third countries is accounted; and finally, different types of agreements are distinguished.

355. To test for trade creation and diversion a standard tool of analysis is used: the gravity model. This methodology has been extensively used by economists to test empirically the determinants of trade flows, and in particular to evaluate trade policy effects. It is particularly well suited for estimating the effect of preferential trade opening on trade flows as this was the purpose in its original formulation by Tinbergen (1962). The state of the art of gravity equation has become very sophisticated. The specification reflects indications from the numerous empirical and theoretical contributions that have allowed over the years to generate consensus around the key features that a well specified gravity model should have. In particular, the chosen specification controls for all unobservable exporter and importer characteristics and for any idiosyncratic factor related to the year, the bilateral relationship, and the individual nation. It also corrects for non-linearity, potential selection bias, heterogeneity and zeroes in the data.

356. One finds that in the period 2005-2010 and for a sample of 181 countries worldwide, PTAs had overall positive trade creation effects. These effects however stemmed completely from deeper PTAs, with shallower PTAs having a statistically not significant or weakly significant effects overall. Turning to the effect of PTAs on Pakistan's exports, it appears that signing PTAs has not boosted Pakistan's exports. By contrast, they did not have trade diversion effects on Pakistan's imports from third country. On the contrary, they made Pakistan more attractive as an export destination also for the rest of the world.

357. Having quantified the trade creation and trade diversion effects of Pakistan's PTAs, whether Pakistan's exports suffered from trade agreements between third countries is tested. More specifically whether Pakistan's exports have suffered from trade diversion generated by any of existing PTAs notified to the WTO is quantified. While PTAs in aggregate do not seem to have noticeable trade diversion effects, they do for exports of Pakistan. Pursell et al. (2011) notes that the complex system of regulatory duties set in place to protect domestic producers of import competing goods may indeed be a source of trade diversion costs. Since countries having signed PTAs with Pakistan are exempt from the regulatory duties foreseen in Pakistan's tariff system, this may ultimately lead to protect its own high cost producers and high cost producers in the preferential supplying country, leading to trade diversion costs for Pakistan itself.

358. Interestingly Pakistan also appears disadvantaged in terms of its geographical position and the strained trade relations with its geographical neighbors. More specifically, while the elasticity of Pakistan's exports to tariff changes is in line with the world average, Pakistan's trade seems to be more elastic to trade frictions than the world average. The elasticity of Pakistan's trade to distance—a common proxy for trade costs—is about 30 percent higher than the world average. Sharing a border (contiguity) usually facilitates trade. In the case of Pakistan sharing a border appears to represent an additional substantial burden to trade. Not only sharing a border appears to be a trade cost for Pakistan's exports, but the overall effect is so important that it doubles the cost of distance. In other words, exporting to two equidistant locations, one in a neighboring country and one in a non-contiguous market, implies twice the cost if exports go to the neighboring country. These insights are confirmed if actual vs. predicted flows are compared. Trade with India is 40 percent below its predicted potential (Figure 61). Similarly, Pakistan is the key missing market for India (Figure 62), once more confirming that both countries would gain by a normalization of their trade relations.

Figure 61. Pakistan's Predicted vs. Actual Exports

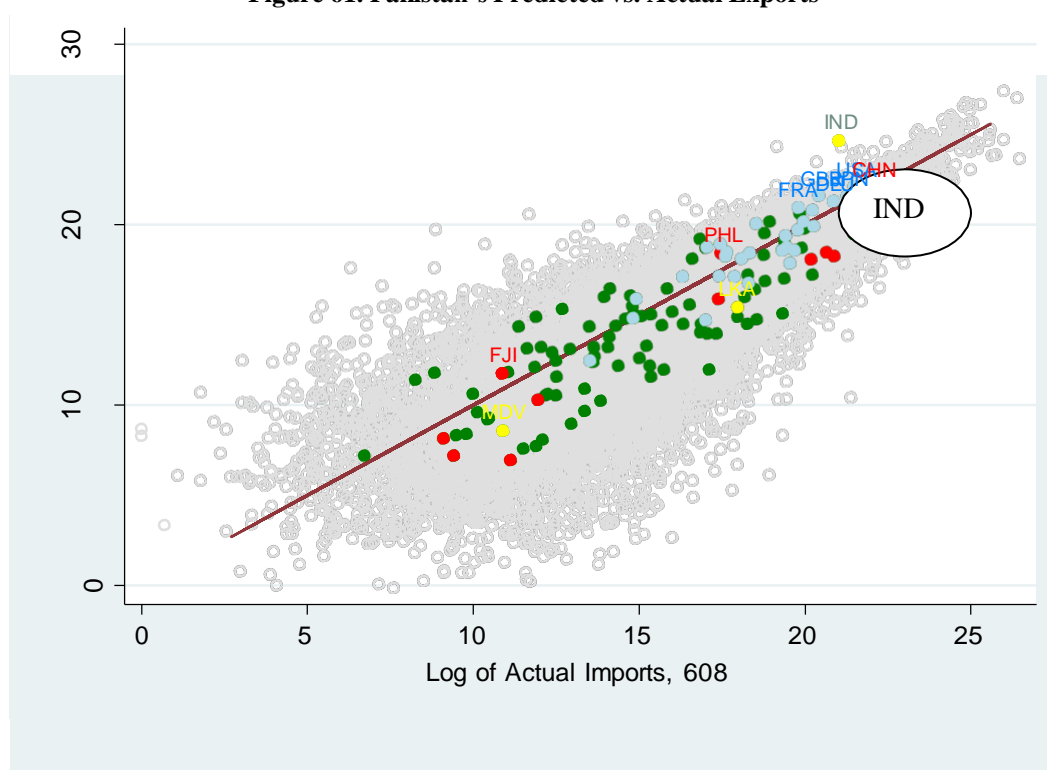
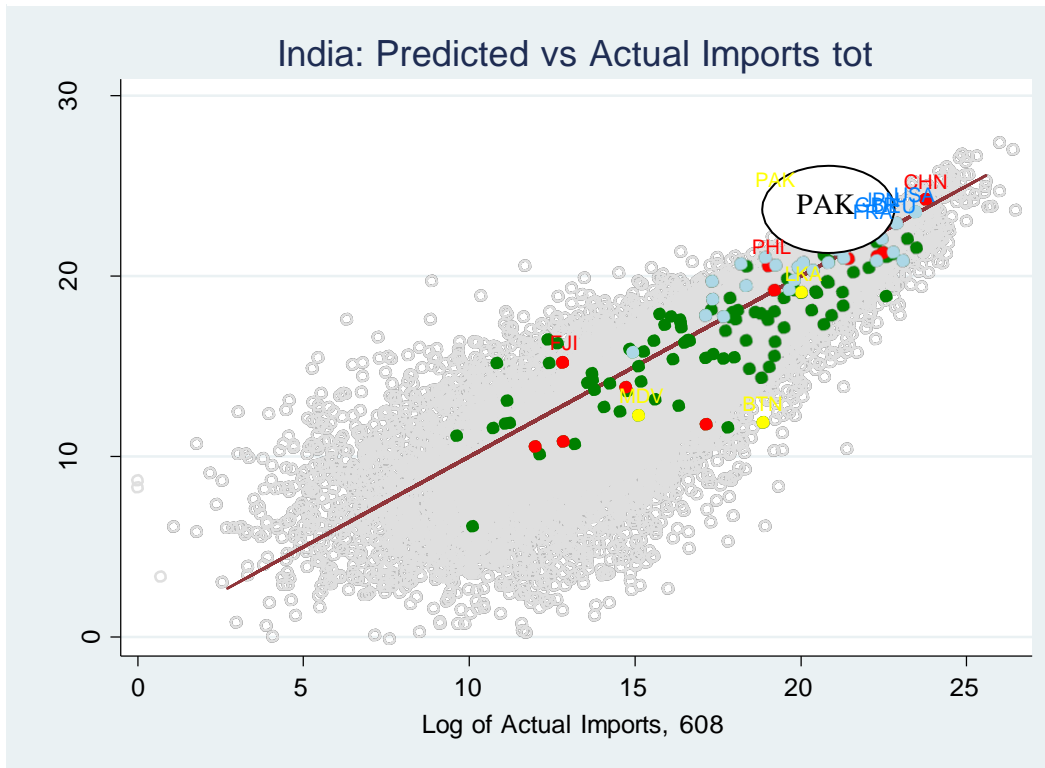


Figure 62. India's Predicted vs. Actual Exports



H. PTAs Impact on Export Growth

359. While the previous section has followed a mainstream approach to evaluating preferential trade policy in Pakistan, this section goes beyond aggregate values and average effects. It looks at the impact on individual exporters' decisions. There are several advantages in quantifying the impact of trade policy directly on individual firms' export flows. Most importantly, it allows looking at the impact of trade policy on different types of decisions the firm makes: whether to start exporting vs. entering in a new market or increasing the product range of exports. Discriminating is important for policymakers as modifying the impact of trade policy on these decisions requires different policy actions. Moreover, it allows one to address a common criticism of aggregate analysis: the identification of heterogeneity in the treatment effects.

360. Given the above, one first investigates how the growth of exports along the various margins of trade evolves over time. Looking at the time evolution of the margins of trade is useful on account of the gradual shift of trade policy in the past decade, from a relatively simple framework based on multilateralism and unilateralism to a more complex framework of preferential trade agreements and exceptions. Second further tests will be carried out by means of econometric analysis, with preferential trade agreement variables. For both exercises, export growth performance along the firm, market and product margins are quantified, as well as at the intensive margin. Outcomes at the extensive margin as a measure of diversification are interpreted. The extensive margin is defined as a new flow, where one further distinguishes between new firms starting an export activity (firm diversification), an incumbent exporter entering new destinations (market diversification), and an

incumbent exporter exporting new products in destinations where it is already present (product diversification).¹⁴¹

361. Starting with the decomposition of export growth, one can quantify the contribution to overall annual export growth in the period 2002-2010 of each of the margins of trade, and within each margin one can further decompose the contribution of entries separated from exits. Export growth is computed using the so called “mid-point growth rate” (Davis and Haltiwanger, 1992 as applied to firm-level exports Bricongne et al. 2011). An interesting fact emerges from the export growth decomposition. Namely, entries and exits at the firm, sector and product level have declined over time, possibly indicating a decrease in the dynamism of exports in Pakistan, a stronger positional advantage of incumbent exporters and a lack of incentives for the latter to innovate. Many important changes took place in Pakistan over the past decade, which may explain these trends in firms' export growth.

362. Accordingly, the econometric assessment quantifies the effect of preferential trade policy, estimating separately shallow and deep PTAs. It does so by controlling for the impact of tariffs, exchange rates, fixed costs to export and foreign demand on the ability of firms to increase their exports at the intensive margin and at the extensive margin.

363. Once one controls for traditional determinants of exports, including developments in foreign demand, exchange rate, and a proxy for the fixed costs to export—that are approximated with the change in total number of days for handling customs procedures (summing costs at the importer and exporter side)¹⁴²—one find that the key results on the effects of preferential trade policy that emerged from the gravity equation on aggregate flows are confirmed by the micro-data. Shallow PTAs do not seem to have a statistically significant impact on firms' exports, while deep PTAs have a positive and significant impact. Engaging into a deep PTA may increase firm exports by up to 21 percent. Meanwhile, one finds that changes in the average tariff level have no significant impact on export growth but the complexity of the tariff regime does. One standard deviation increase in tariff complexity implies a reduction in firms' exports by 13 percent.

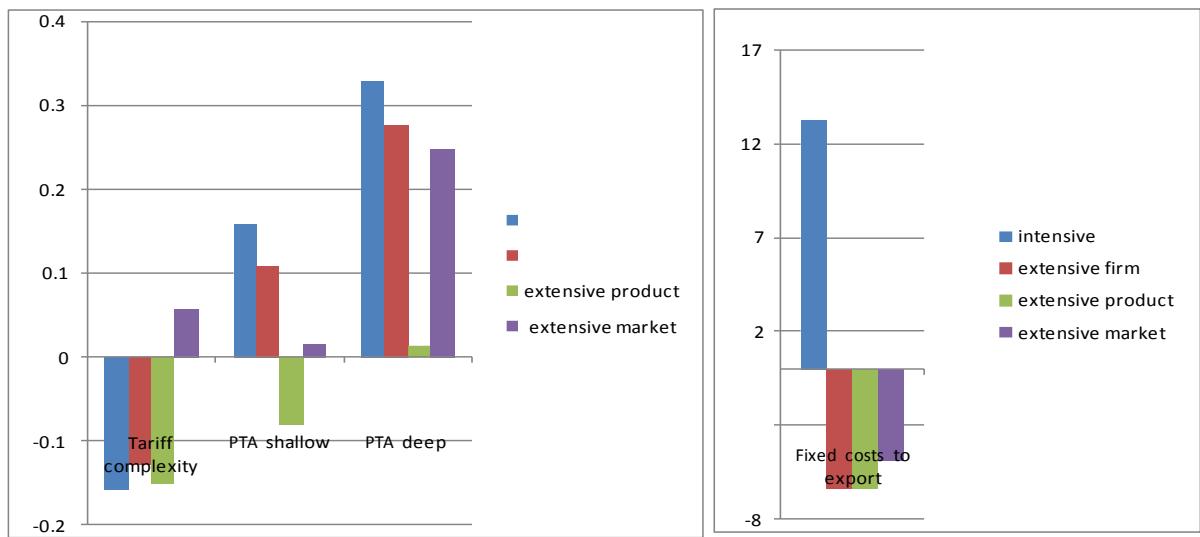
364. The econometric framework allows determining the effect on each margin of firm export growth of the trade policy stance. Accordingly, the overall non-significance of shallow PTAs for trade appears to be the result of contrasting effects on the various margins of trade. Indeed, shallow PTAs have a positive effect on the intensive margin of trade. They also seem useful in bringing more firms to export and to expand the number of markets served. However these effects are fully offset by a dampening in terms of product variety. In other words, shallow preferential agreements are likely to create market distortions that dampen firms drive to innovate and diversify. By contrast, deep PTAs seem to have positive trade creation effects along all margins. Tariff complexity on the other hand seems to be a burden for firms' ability to start exporting, for their ability to increase the volume of exports at the intensive margin and for their propensity to diversify. Finally, the fixed costs to export appears to be by far the most important impediment to export diversification, having a sizeable and statistically negative effect on all the extensive margins of trade. Not surprisingly, the negative effects at the extensive margin are partially offset at the intensive margin. Arguably,

¹⁴¹ Note that this definition involves a hierarchy along the different dimensions of the extensive margin. That is to say, product diversification is contingent to a firm being already an exporter serving the same market. We keep this pecking order along the text.

¹⁴² While this is only a partial measure of fixed costs to export, we assume that it is representative of more general issues. We assume that a reduction in the number of days for customs handling is likely to be correlated with a more general public effort to reduce a range of costs affecting firms.

burdens to export are likely to create a competitive advantage for incumbents (Figure 63 provides a graphical representation, where their effect is benchmarked against the effect of the other trade costs variables in the specification).

Figure 63. Determinants of Export Growth and Diversification



CHAPTER VI. TRADE POLICY RESEARCH AND ANALYSIS

A. Introduction

365. Following a renewed focus on the importance of global competitiveness and integration for growth and poverty reduction, the Ministry of Commerce (MOC) launched an initiative in 2007 to develop an institute capable of providing policy advice backed by high quality research and analysis. New leadership was set in place in July 2007 at the *Foreign Trade Institute of Pakistan (FTIP)* to transform what had essentially been the training institute for officers of the Commerce and Trade (C&T) Group occupation category of the federal civil service, into such an institute. A government change in March 2008 saw continued support for the FTIP restructuring, and a revamped institute, renamed the *Pakistan Institute of Trade and Development (PITAD)*, was launched in January 2009.

366. The Bank's involvement with the FTIP began in 2008 when in a show of support by the Commerce Ministry, the institute was designated to receive the MOC's allocation of funds from the World Bank's Pakistan Public Sector Capacity Building Project (PSCB). In this context, the World Bank Institute (WBI) was invited by the FTIP to assess its capacity building needs and prepare a Capacity Building Strategy and Implementation Plan to achieve the dual goals of improving its training capabilities and developing its research capacity. A report was prepared in June 2008 which outlined proposals for implementation in the short and medium term with respect to institutional design, scaling up training programs, research capacity building, and outreach and policy dissemination.

367. In a short period, the FTIP/PITAD made significant strides in its transformation, exhibited dynamic growth and attempted to fill a void in a lackluster national research environment on competitiveness and integration. In the meantime, the Bank moved beyond a *retail model* of research support to developing countries (where Bank staff provide research outputs) to one that included a *wholesale model* (where the Bank provides data and analytical tools so that researchers in developing countries are able to produce research themselves and develop home-grown solutions to policy problems). In this context, and consistent with the South Asia Regional strategy and the country partnership strategy, Non- Lending Technical Lending Assistance (NLTA) was extended to Pakistan to support evidence-based policy making. The aims of the NLTA were to provide activities and advisory services to PITAD that aimed to (i) build its research capacity, (ii) upgrade its training function, and (iii) coalesce and stimulate a disjointed trade research community under PITAD's leadership, thus boosting the research output of the wider community and promoting policy discussion and debate.

368. This section covers the activities of the NLTA in support of PITAD, outlines its results and outcomes in terms of PITAD activities and developments in trade policymaking in Pakistan. It makes the case for continued support to PITAD and identifies strategies to consolidate and accelerate the significant progress already made by PITAD. The section is organized in the following manner. Trade policy context and the institutional context in which PITAD operates is discussed and recommendations provided. Then a brief profile of PITAD is provided, followed by the context for the NLTA in terms of the Bank strategy of research capacity wholesaling, as well as its role with the strategy for the region and the country with a description of the activities carried out to strengthen research capacity, support training and coalesce the wider trade community. The results and outcomes of these activities are discussed and the case for continued support to PITAD based on these results and outcomes is provided. The way forward in terms of design and implementation strategies for capacity building in the short and medium term to upgrade its training capacity,

strengthen its research capacity and catalyze the wider trade community is discussed, as well as the potential scope for Bank support within this framework.

B. Institutional Context of Trade Policy Analysis

369. The Commerce Ministry has nine wings: Import, Export, and Foreign Trade-I, Foreign Trade-II, Foreign Trade-III, Administration, International Trade Organization, World Trade Organization, and Trade Organization Wings. It has over 50 Trade Offices in 40 countries. The Ministry also has eight statutory/autonomous/semi-autonomous bodies under its administrative control: Trade Development Authority of Pakistan, National Tariff Commission, Pakistan Institute of Trade and Development, Pakistan Tobacco Board, Trading Corporation of Pakistan, State Life Insurance Corporation, National Insurance Company Limited, and Pakistan Re-Insurance Company Limited.

370. Institutional reform to support the Commerce Ministry in achieving the national goals of the rapid export growth has been focused on three agencies (i) The Trade Development Authority (TDAP), (ii) The National Tariff Commission (NTC), and (iii) the Pakistan Institute of Trade and Development (PITAD) formerly known as the Foreign Trade Institute of Pakistan (FTIP).

371. *The Trade Development Authority of Pakistan (TDAP)* was created in November 2006 through an Ordinance to replace the Export Promotion Board (EPB), which since 1963 tried to expand exports, on the demand side by exporter participation in exhibitions abroad and sending delegations to export markets, and on the supply side by establishing 32 sector training institutes. The TDAP has been given a wider mandate than the EPB that includes export marketing (market research, fairs and exhibitions, trade delegations abroad), communication (publication of trade inquiries/opportunities, export intelligence bulletin, statistics), human resource development (training institutes, training on TQM, social, regulatory and environmental compliance concerns) and regulation (developing and implementing trade policy, issuance of GSP certificates). The TDAP is not an attached department like its predecessor, and has financial and administrative autonomy, reporting directly to a Board chaired by the Minister of Commerce, and consisting of public and private sector stakeholders. This is expected to boost the effectiveness of the institution, by making its activities more relevant, allowing it greater freedom for quick response actions and reducing bureaucratic hurdles. TDAP's successes have been centered around the participation in trade fairs and trade delegations. Since the inception of the new institution, there has been a significant increase in these marketing activities with substantial subsidization of costs for exporters financed through a tax on exports. However, the TDAP is weak on research.

C. A Transformative Paradigm—From FTIP to TDAP

372. The Foreign Trade Institute of Pakistan (FTIP) was created in 1989 within the Ministry of Commerce with the goals of providing training, research and information dissemination. By the FTIP's self-assessment (Yatawara, 2008), the Institute's performance was "largely focused on training with very little work on research and dissemination" and characterized by a "weak outreach program" and "poor linkages & networking." The need for the PITAD to acquire technical research expertise was first highlighted in the Trade Policy Speech of 2004/5 by the Government to the Parliament, which called for FTIP upgrading.

“The Foreign Trade Institute of Pakistan (FTIP) will be strengthened by enhancing the capacity of the Institute faculty. The physical resources of the Institute will be improved and it will also be shifted to a new building with adequate space and facilities. The upgraded Institute will be tasked to carry out research and conduct periodic refresher courses.”

373. This led to the reconstitution of the FTIP Board of Governors to include more representatives of the private sector and the hiring of a consultancy firm to analyze the strategies of restructuring the FTIP to achieve its original goals. A new Director- General (DG) was hired in December 2006, and took office at the FTIP headquarters in July 2007. In the Trade Policy Speech 2007/08 (July 2007) the Minister of Commerce addressed the need for institutional reform, stating that the ministry’s effectiveness was restricted by the lack of an effective research arm, and committed resources to revamping the FTIP.

374. A major constraint in the past has been the lack of effective research and information on multipronged trade and globalization issues. The FTIP was created in 1989 with the objective of providing this research base but in fact was reduced to an average institute providing some training to new officers of the Commerce and Trade Group.

375. In order to plug the original research gap, the Government has decided to replace the FTIP with the Trade Competitiveness Institute of Pakistan.¹⁴³ In addition to conducting policy research on all key aspects of trade competitiveness, this institute will be the premier body for capacity building and human capital development on commerce. This Institute will also provide an important forum for the discussion and dissemination of information on issues of commerce. For enhancing the capacity of this institute to carry out its changed role effectively; a PC-I Rs.130 million¹⁴⁴ has already been approved by Planning Commission.

376. Since July 2007, the Institute has been in an active restructuring process with a new mission aimed at producing “quality research inputs, trained human resources and policy advice to all stakeholders to make them competitive in their respective domains/ sectors, nationally and internationally.”¹⁴⁵

D. PITAD Structure and Management

377. The PITAD is under the administrative control of the Commerce Ministry and was declared a semi-autonomous body through a Resolution. All financial requirements are met by the Federal Government. Management structure. PITAD’s management structure was revamped to suit its new research function. It is headed by a Director-General, and has 3 Directors for training, policy and research, and administration/finance. The research wing has an additional “Joint Director” of Research. The Institute has been graced by strong, effective results-oriented leadership—first with Dr. Safdar Sohail as Director General through June 2010 and then with Mr. Asaf Ghafoor at the helm. Both hail from the civil service cadre of the Commerce Ministry with expansive trade experience. Under the new leadership, there has been a greater emphasis in providing analytical inputs for evidence-based policy making at the Commerce Ministry.

¹⁴³ The name finally settled at Pakistan Institute of Trade and Development.

¹⁴⁴ Approximately US\$2 million at the time, at the June 30, 2007 exchange rate of Pakistani Rs. 60.95 per US dollar.

¹⁴⁵ Yatawara (2008).

378. There are currently 12 staff actively pursuing research, including the Director General. PITAD has not reached its full staff strength, and actively seeks well-trained staff. The Director Research has a PhD in Economics from Australian National University, Canberra. There are 4 senior research associates and 4 research associates. The senior research associates typically have a Masters in Economics, and at least 2 years of research experience. The young staff are of high quality, hardworking, energetic and eager to learn. Fifty percent of the senior research associates and the research associates are women. Employees receive wages substantially higher than typical government employees, but these salaries are still lower than those in the private sector for similarly qualified individuals. New employees are hired on a contract basis, while some commerce ministry are seconded to PITAD.

379. Currently the office is located at State Life Building No.7, Jinnah Avenue, Blue Area, Islamabad. Although located in an old building, the PITAD office space was overhauled into a nice modern open space office area, with new furniture and new computers. Land has been procured and financial resources allocated by the Ministry of Commerce to construct a building for the PITAD in Sector H-9, Islamabad, but currently there is no mobilization of resources for construction.

E. Research Activities

380. The principle areas of research and policy work listed are:

- Trade liberalization and its impact on the economy
- Market access strategies and trade integration
- Trade competitiveness
- Trade promotion and trade facilitation
- Barriers to trade
- Comparative analysis of competitors' trade policies
- Domestic commerce
- Trade and the environment
- Technology and innovation

381. Since the restructuring, much research has been conducted and presented in Pakistan and in the South Asian region. PITAD conducts research in-house as well as through partnerships with outside researchers/institutions and also manages research studies outsourced by the MOC. Much of the work has focused on analyzing preferential trade agreements and sector competitiveness. PITAD is also actively pursuing an innovation policy study, devising strategies to spur innovation through public-private partnerships (government-academia-industry) that would in turn increase the quality and competitiveness of Pakistani products.

382. Training activities: The main training programs offered are listed below:

- *The Specialized Training Program (STP)* is the core training program offered annually by the PITAD. It is a 9 month comprehensive course, offered to entry level candidates of the Commerce and Trade (C&T) Group of the Ministry of Commerce. The annual entry class size ranges from 10 to 20 candidates, depending on the retirement of the C&T cadre which amounts to about 345 officers. The course covered basic theory of microeconomics and trade, Pakistan's current trade patterns and issues, trade laws, WTO issues, export promotion and business management. There is also a research component which involves a sector-wise analysis.
- *Capacity Building Program* is a 12 day program with two modules, designed for mid-level C&T officers at the BS17-19 levels. The training was mandatory for promotion until May 2007.
- *Orientation Course for Commercial Attaches* selected for posting abroad. This training has a one week duration covering current trade issues, trade diplomacy, marketing Pakistan's exports, and WTO issues, among other topics.
- *Foreign Service Academy Training* is a one week training designed for newly inducted Pakistani diplomats being posted abroad to promote Pakistani exports more effectively. This is a one week course for training diplomats prior to departure on foreign postings, on areas such as export promotion, investment policies and tourism promotion.

383. Recent introductions to the portfolio of courses include:

- *Executive Post Graduate Diploma Course* was delivered "Applied Quantitative Research Techniques" catering to both the public and private sectors. Twenty-four participants completed the course.
- *Capacity Building program for Economic Journalists* was conducted in collaboration with Journalists for Democracy and Human Rights. The course was designed to increase the understanding of the complexities of globalization and improve the quality of economic reporting.

384. *Outreach and Policy Dissemination:* The PITAD has played an information dissemination role by organizing seminars and conferences on relevant topics, exposing stakeholders to new information and research on current issues and those directly related to their research program above.

F. The New Strategy for Research

385. As outlined in President Zoellick's speech at Georgetown University on "Democratizing Development Economics" (September 2010) and the subsequent elaboration in World Bank publications, the Bank is embarking on a new approach to developing new solutions to the most pressing problems facing developing policymakers. The field of development economics has sometimes focused on questions that new data and new analytical tools can address, rather than priority issues and key knowledge gaps in development policy. Further, a greater focus is needed on the results of development policies and projects, to assess their effectiveness. It is important to adopt a practical approach to research, with its policy relevance being the fundamental objective of the work, as opposed to a by-product of academic pursuits.

G. Activities Under the NLTA

386. The activities carried out under the NLTA were carried in accordance with client priorities, and the Bank budgetary and time constraints. The goals of PITAD are to provide quick response, high quality policy analyses to support evidence-based policy making at the MOC, longer analyses to support effective monitoring and evaluation of trade-related policies and outcomes, and longer term research on trade and competitiveness that would catalyze proactive policymaking, and offer opportunities for high-quality trade research economists to contribute intellectually to the global trade research community.

1. Research Capacity Building

387. Activities carried out under the NLTA in support of PITAD included

- identification and prioritization of capacity needs
- delivery of capacity building activities
- design of strategies for implementation of capacity requirements.

388. ***Research advisory services.*** Research advisory services were broad ranging and focused on reinforcing a strong foundation of fundamental skills as well as introducing frontier research topics and methodology. A common goal was established, and services provided included reviewing studies already drafted, assessing ongoing research work and designing approaches for new research on various trade topics ranging from preferential liberalization, non-tariff measures (NTMs) that affect trade, war on terror impacts on trade, and competitiveness of the textile industry, gender and trade, among other topics. Inputs varied from offering analytical content review to research design ideas, alternative methodological approaches, encouraging use of more disaggregated data, discussion of econometric results as well as quality control and confirmation.

389. ***Leapfrogging to the research frontier.*** Trade topics and methodologies (including new data sources) that were gaining momentum in the global trade research community were discussed. Presentations were provided to various government officials on the additional value of using *customs transactions data* to analyze export dynamics such as exporter firm survival.

390. ***Initiated joint- research.*** A research proposal was developed to work jointly with the Director Trade Policy and junior researchers to analyze the likely impact of EU's trade concessions awarded to Pakistan to accelerate recovery after the devastation of the great flood of 2010. In the context of this work, introductory training on the statistical package STATA was provided to two young researchers.

391. ***Building a database of local data.*** A comprehensive proposal was produced to develop a trade database and portal to support research analysis, policy monitoring and evaluation (there is currently no national historical trade database in Pakistan). The key is to have access to the most recent data along with historical data, at the appropriate level of disaggregation through an easily accessible portal. Researchers tend to use international data sources from the World Bank, IMF, UNCTAD or ITC (e.g. TRAINS, COMTRADE). While these data provide a consistent dataset for cross-country comparison, they also have limitations that a PITAD database could address. First, there is a significant lag in reporting internationally comparable data, but national policymakers and the private sector are always interested in the latest data. Second, international data of trade flows are

consistent only at the HS 6 digit level of product disaggregation, when in fact much of trade policy in Pakistan is carried out at the more disaggregated HS 8 digit level, thus a database of trade flows at the 8 digit level is needed. Further, since local sources only provide data on the internet for a couple of years, or not in a format that facilitates analysis (e.g. 8 digit level tariffs in PDF document format), it will be worthwhile to create a national historical database that is updated as soon as data is released locally. The PITAD should maintain a monthly trade flows data set, which would also allow quarterly, and annual (both calendar year and July-June financial year) comparisons in trade flows. The trade flows data should be merged with the data on tariffs and other policy indicators to facilitate analysis.

2. Training Activities

392. **Trade Indicator Training.** A structured training was provided on trade indicators, highlighting the breadth of indicators to assess a country's trade and competitiveness profile, and pointing to the newest indicators that are publicly available. In particular, attention was drawn to the World Bank's Open Data Initiative, with particular reference to *WITS-World Integrated Trade Solution* and <http://wits.worldbank.org/wits/> and the World Trade Indicators (WTI) 2010 www.worldbank.org/wti. The WTI is an innovative benchmarking and ranking tool that provides a nation the ability to compare its trade and competitiveness profile vis-à-vis other countries. Various indicators were surveyed to develop a country's trade profile under (i) trade policy, (ii) market access and external trade environment, (iii) business environment, (iv) trade facilitation and (v) trade outcomes. A training was provided on the Trade Indicators to the staff from the research department of the State Bank of Pakistan (8 people in Karachi).

393. **Structured Learning - lectures on the Global Recession.** Two topics were presented: "Recent Trade Developments and the Global Recession", and "Policy Responses During the Recession" for 34 civil service cadre that had joined the commerce ministry in addition to the 9 research staff of PITAD. Topics included the expansion of trade from 2002, the food, fuel and financial crises, the trade collapse, analyzing the causes of the trade collapse, and the reasons for the differential impacts of the recession on goods versus services trade. The second lecture looked at the policy instruments available to a country in responding to the global recession, documented the use of stimulus packages, prevalence of trade remedy actions and growth of non-tariff measures and relatively mild use of tariff increases. Discussion followed on why the protection seen was not as dramatic as during the Great Depression of the 1930s. The usage of newly available data was highlighted.

394. **Working with PITAD foreign donor partners.** The International Food Policy Research Institute (IFPRI) and the US Commerce Department were engaged to assure that PITAD training was consistent, and training initiatives were identified that could be funded by other donors that were beyond the scope of the current NLTA. In collaboration with the US Commerce Department's Commercial Law Development Program, a training was provided on non-tariff measures to a delegation of Pakistani trade officials.

395. **Advisory services on re-engineering the STP.** Discussions were held on the content covered in the revamping of the STP course carried out by PITAD in collaboration with the World Trade Institute.

396. **Preferential Trade Agreements Course proposal.** Since regional trade integration is a key component of MOC trade strategies, a course on the latest issues in preferential trade agreements

(PTAs) is appropriate. The key components of such a course would include theoretical considerations, empirical methods used to analyze PTAs, relevant topics to be negotiated as well as implementation issues and the political economy of regional integration.

H. Coalescing the Trade Community, Building partnerships, and Outreach

397. *Assessment of the Trade Research Landscape in Pakistan.* As part of the piloting exercise of the Trade Department's Export Competitiveness Toolkit, discussions were held with several private sector firms, chambers of commerce, business associations, academic institutions, research institutes and governments institutions. The visits provided an opportunity to survey the trade research landscape in Pakistan. The key features of the trade research landscape are listed below.

- *Small, diffused and disconnected trade community.* The community of trade researchers is small, and spread mainly over Islamabad, Karachi and Lahore. There was little evidence of collaboration outside the relevant institution.
- *Lack of trade specialization in institutions and individuals.* Apart from PITAD, there was no institution that researchers would readily identify as a trade research institute or an institute or university that had a strong trade department. In the 1980s and early 1990s, the Pakistan Institute of Development Economics (PIDE) was known for its strong trade focus, but that is not so currently. Similarly, there did not appear to be much of a trade specialization among economists. Pakistani economists have produced some good quality trade work but not in a consistent fashion. There was no prominent economist that could be labeled an eminent *trade* economist.

398. The contributing factors to include:

- *Insufficient research incentives in academia.* Until recently, career advancement of entry level university lecturers/assistant professors was not significantly tied to academic research output. Lecturers contributed to consultancy work taken on by the Economics department, but academic publications were not a priority.
- *Previous neglect of trade policy in the public policy agendas.* The relegation of trade policy in government priorities reduced the demand for trade-related analytical work.
- *Donor-driven research agenda.* The research agenda of development economists have become donor-driven in many instances. Universities and research institutes seeking funding opportunities cater to the demands of the donor community. As trade was not a priority agenda item among donors, the trade work has been limited in the lead up to Pakistan reserves crisis in 2008 and the global recession.

399. Emerging developments in the economics research community are:

- *Recent growth of policy research institutes.* There has been a significant growth in research institutes and consultancy firms, often started by high profile former government officials or Pakistani nationals who have returned from working in international organizations. While these are high quality economists with well-deserved reputations, none would be readily identified as trade economists. Similarly, these research institutes are also broad in the scope of the work they undertake.

- Scarce mid-level human capital. There is a scarcity of well—trained trade economists and in particular those with doctorates that are at the peak of their productivity. Instead, there are successful older economists and a very talented group of young economists.

400. ***Organization of meetings with trade data producers.*** Meetings of PITAD with data producers at the State Bank of Pakistan and the Bureau of Statistics were organized. Previously such meetings were not typical.

401. ***Quarterly International Trade Monitoring Report proposal.*** This would be a quarterly update on Pakistan trade situation which would be about 8 pages long. The objective would be to provide a brief analysis (two pages) of the most recent quarterly trade outturn and significant trade policy developments at home as well as international developments that would have an impact on Pakistan. The rest of the publication would be a series of figures and tables, highlighting aspects of the quarterly developments in the context of historical quarterly data. This would be an exercise where the costs would involve initial high fixed costs of choosing the appropriate indicators and setting up a template. Once the template is setup, the goal is to have this publication be a low variable cost exercise. A trade profile using annual aggregate indicators could be placed under 4 categories such as (i) trade policy, (ii) market access, (iii) trade facilitation and (iv) trade outcomes.

402. The publication would also involve capturing trends in the levels of quarterly data, as well as growth rates. More disaggregated indicators at the product and market level that would highlight the largest increases and declines of exports and imports at the product or industry level would additionally be included. A similar analysis for export markets and import sources would be displayed. No written analysis would be required beyond chart titles that highlight the main developments. At least 4 pages of the publication should be standardized tables that would be easily updated. The last page may be a continuation of the analysis, provide deeper product level or sector level analysis, contain a list of upcoming trade-related events, or have brief analyses of ongoing work at PITAD that would serve as publicity for an upcoming working paper. Besides writing the two page analysis of the quarterly trade outturn, senior staff need would not be burdened by this report. A natural partner for this endeavor would be the Bureau of Statistics, and this could be a joint publication of the two institutions, and made available on both websites.

403. ***Pakistan State of International Trade Annual Report proposal.*** As PITAD matures, the Institute should be positioned to launch its annual flagship publication, “State of International Trade in Pakistan” by 2014. This report should be of high quality, so that it will become a well-recognized and appreciated publication and PITAD’s largest outreach vehicle.

404. The first part of such a publication could be on trade policy developments and outlook, which would cover domestic policy developments in trade and related policies, as well as international policy developments affecting Pakistan. The Institute’s policy outlook and advice would also be included. Further it would provide a trade outturn analysis—showing trends with aggregated and disaggregated data. It is critical that this section is analytical, and for the first publication an analysis looking back three to five years of trade outcomes is warranted. The second part of the publication would be comprehensive analysis of a particular theme (which would change annually), with the content coming directly from PITAD’s ongoing research program. Given the current work program, a theme such as “Regional Integration” appears appropriate. This section may contain other research work condensed from working papers. Part 3 would be called Policy Briefs and these would be 3-5 page analyses on highly relevant current topics. They could provide brief data analysis, or clarify

issues that are currently in hot debate where it has become hard for the public to decipher fact from rhetoric. The last section would contain a statistical appendix.

405. ***Pakistan Trade and Development Conference (PAKTAD) proposal.*** An excellent opportunity to coalesce the trade community and exhibit leadership would be to organize an annual trade conference to foster debate and dissemination of research work, as well as to ignite further analysis and collaboration. A call for papers should encourage policy related work from government, academia, research institutes and private organizations. Graduate students should be encouraged to apply with a small financial prize for the best graduate student paper and funding to provide accommodation and travel to Islamabad during the conference. The call for papers would typically be 6 months before the conference with paper deadlines three months before the conference.

I. Results and Outcomes: PITAD Progress and Trade Policymaking in Pakistan

406. The items listed below reflect **results** of the technical assistance- some effects are more directly observable than others. While it is difficult to attach a specific degree of contribution, similar to estimating the size of the coefficient of a regression, the technical assistance contributed to these outputs in a statistically significant manner with the anticipated positive sign. The key results are increased awareness of new data, methods and topical directions that trade research was heading, as well as the acquisition and application of such information and skills to produce higher quality, more useful analytical outputs. Clearly, the efforts of PITAD staff are the dominant factor in the successful execution of research efforts.

407. The **outcomes** have been a vibrant and active trade policy agenda carried out by the MOC, with trade integration once again widely recognized as key to competitiveness, inclusive growth, job creation and poverty reduction. Trade policy initiatives taken in consultation with multiple stakeholders, include the historic progress towards normalization of trade relations with India. Such bold policy moves are unlikely to have proceeded without the analytical inputs of PITAD with respect to liberalization benefits with existing free trade agreements, as well as specific work related to the implications of liberalization with India and the identification of the constraints to current trade with India.

- ***Launch of PITAD Working Paper Series.*** In 2010, PITAD launched a working series and posted the working papers on their website. This reflects a confidence in the quality of the work, greater transparency in its function and an interest in dissemination of analytical work to a broader audience. These papers reflect acquisition and application of new knowledge and skills, and incorporation of advisory services.
- ***High quality analytical inputs from PITAD to the Commerce Ministry.*** PITAD has become the key source of analytical inputs to the MOC on a wide range of topics prior to trade negotiations, for policy formulation as well as for trade monitoring and evaluation. Examples of these inputs include analyzing China-Pakistan bilateral trade, exploring the impact of the Pakistan-Sri Lanka free trade agreement on exports to Sri Lanka, and assessing the barriers to trade with India through surveys conducted on the private sector.
- ***Towards Open Data - Release of customs trade transactions actions data.*** Following careful explanations of the benefits of releasing customs transactions to facilitate analysis of trade at the firm level, the Customs Department released Pakistan's data to the World Bank.

- ***Enhanced networks.*** PITAD has developed improved processes for collaboration with external partners to bolster their research capacity and outreach. Working with the *US Commerce Department* (Commercial Law Development Program) has facilitated some training in innovation policy, commercial law and regional integration. Technical trade assistance for the MOC supplied by the EU is also channeled through PITAD. PITAD joined the UN ESCAP's *ARTNeT*—a network of national-level research and academic institutions involved in trade research and located in ESCAP member countries. The network provides opportunities to (i) participate in technical training workshops and other capacity building activities, (ii) participate in ARTNeT research projects and projects from international institutions, (iii) enhance networking with regional trade researchers and institutions, and (iv) expand dissemination of research to policymakers and researchers through the ARTNet website. PITAD is also using MOC's *commercial attaches* as sources of market information in the countries they are based, in addition to their export promotion role.
- ***PITAD building relationships with local data producers.*** The PITAD leadership has also begun to develop cooperation with the Federal Bureau of Statistics.
- ***Enhanced networks for upgrading training program.*** PITAD has developed improved processes for collaboration with external partners to re-engineer their training program. With regard to training, they have established a twinning agreement with the World Trade Institute (WTI) in Germany to support the restructuring of their hallmark STP course. Faculty from the WTI work with faculty from PITAD on developing new modules for the course.
- ***MOC Coalition Building for policy making.*** PITAD's policy work which has included surveys of the private sector, has increased the MOC's ability to generate coalitions for reform. First, analytical work that also incorporates stakeholders feel their voice has been heard. Second, the awareness that policy initiatives are backed by analytic work, and policy monitoring will follow to capture unanticipated effects, gives stakeholders greater confidence to support reform and reduces their fears of departures from the status quo.
- ***Vibrant and active trade policy agenda including the bold move to normalize trade relations with India.*** These initiatives have the potential to not only stimulate exports, growth and job creation in Pakistan, but also unleash regional integration and shared prosperity in the South Asian region. Policy initiatives include:
 - *Normalization of trade relations with India:* The plan to liberalize trade with India was announced in April 2011, with the announced intention to convert the positive list of allowable Indian imports to a "negative list". The two sides also agreed to improve trade infrastructure and expand trade through the Attari-Wagah land route. Following the February 2012 first visit to Islamabad for substantive meetings by an Indian Minister of Commerce, the implementation of the negative list took effect on March 20, 2012 with the SRO 280(I)/2012- Amendment to Import Policy Order 2009. Pakistan is also expected to extend India its long withheld MFN (most-favored nation) status in January 2013.
 - The year 2012 was declared the "Year of Regional Trade and Economic Connectivity" by the Prime Minister.

- Liberalization obligations were met under the SAFTA with a reduction of 233 tariffs lines (20 percent of the 1,169 items) under the sensitivity list the SAFTA agreement.
- The Afghanistan –Pakistan Transit Trade Agreement was signed in June 2011.
- Pakistan joined the CAREC (Central Asia Regional Economic Cooperation) as a full member in 2011, to promote cooperation in implementation of regional projects in energy, transport, and trade facilitation among Afghanistan, Azerbaijan, China, Kazakhstan, Kyrgyz Republic, Mongolia, Pakistan, Tajikistan, Turkmenistan, and Uzbekistan.
- Connectivity was increased with the Middle East and Central Asia through the ECO (Economic Cooperation Organization) e.g. Islamabad –Tehran-Istanbul container train -2010.
- Aggressive and fruitful trade diplomacy took place to obtain tariff concessions under the EU GSP+ scheme.

408. ***Importance of trade liberalization entrenched into development strategy.*** After a period, where trade and trade policy was neglected, a consensus has built up on the importance of trade integration for prosperity and job creation, and this culminated in the substantial role given to trade liberalization in the new growth strategy of the Planning Commission.

J. The Case For Accelerated World Bank Collaboration with PITAD

409. ***Demand-driven, client-owned initiative.*** The goal of enabling evidence-based policy making was an initiative of the MOC. PITAD has a strong mandate from the MOC, and in the last year there has been greater clarity in the relationship between PITAD and the MOC. The PITAD plays an important role in supplying inputs to support trade negotiations, policy formulation, and policy monitoring to assess needs for policy recalibration. Strengthening research capacity at this time would be an essential, appropriate and compatible component of the MOC's overall institutional reform package which includes an active Trade Development Authority of Pakistan doing export promotion, the National Tariff Commission handling contingent protection and unfair trade practices, and the PITAD providing training and research in trade issues.

410. ***Bold trade strategies require effective monitoring for sustainability.*** Given that the MOC has launched into bold strategies that would not only be beneficial for Pakistan, but also for the entire SAR region and Central Asia, it is important to support initiatives that would support sustainability of the reforms. Quick, accurate and effective monitoring would be needed to identify losers of reform and any unanticipated developments so that the MOC could take any remedial measures to foster inclusive growth. It is only with a well-equipped team that effectively analyzes developments are reforms likely to be sustained. In particular, given the size of India, the magnitude of effects may be large, and thus quick, effective analyses are crucial.

411. ***Immature local trade research environment.*** The erosion of the trade and competitiveness research environment in Pakistan needs support to incorporate new issues and methodologies that have engulfed the field such as the trade in tasks, heterogeneous firms, services trade and off-shoring, and trade facilitation. These new lenses of analyses are important for discussing traditional issues like regional integration.

412. ***PITAD First Mover Advantage and Specialization.*** PITAD has clearly developed a first mover advantage and created a concentration of researchers around trade and competitiveness issues. Thus it is the clear choice for which to supply capacity development assistance. Given the immature state of the trade research community, PITAD support could also be channeled to coalesce the trade community and catalyze analytical endeavors to support policy formulation and results monitoring. Support from the World Bank in a larger fashion than previously and for a longer period (e.g., 3 years) would also provide additional credibility to this young organization, in an incubation phase. It would provide an attraction to prospective employees who would recognize opportunities for research capacity development and joint work with World Bank staff.

413. ***Result-oriented leadership at PITAD.*** The excellent development track record of PITAD may be attributed to its effective leadership, first with Director-General Dr. Safdar A. Sohail, and currently with Director- General Mr. Mohammed Gafoor. Under the current leadership, PITAD has consolidated its functions and shows clarity of mission. In the absence of substantial Bank assistance, it has developed alternative networks to support development of its training program, but still needs sustained effective support on the research capacity development.

414. ***Needs match strengths and imperatives of the Bank.*** Given the commitment from the MOC and the resulting availability of financial resources for the expansion of PITAD, the main constraint to growth is in the technical aspects of building research capacity. Given the lack of surplus trade researchers and a strong trade research community in Pakistan, the Bank has an important role to play to provide training in analysis of trade and competitiveness. Assistance to PITAD would be consistent with the Bank's strategy to incorporate a "wholesale" strategy to analytical work, so that local researchers are empowered with technical skills to design insightful national strategies for inclusive growth and poverty reduction. Using technical expertise within and outside the World Bank, the Bank would be able to effectively advise PITAD on building research capacity, and actively help nurture such research capacity through learning-by-doing, by partnering with the PITAD on some projects.

415. ***PITAD ready for absorbing greater assistance.*** The infrastructure has been set up at PITAD and the young researchers have a firm foundation from which to execute competent analyses. It is now an appropriate time to provide increased capacity development assistance as the researchers at PITAD are at a stage that they would be able to absorb and exploit more sophisticated Bank assistance effectively. The more senior researchers would also likely to find the Bank assistance catalytic. Thus the Bank would have high returns to this assistance.

416. ***Forum for trade policy formulation and analysis.*** Given the fragmentation of the trade policy formation process and jurisdiction over different policy instruments, the PITAD could also play an important role of not just bringing government and non-government stakeholders together, but also in convening the various different ministries and government departments that influence trade policy. This would promote greater harmonization of policies, as well as a clearer mandate and more efficient scope of work for different departments and ministries.

K. The Way Forward

417. The following outlines recommendations in terms of design and implementation strategies for PITAD to achieve goals of strengthening research capabilities, scaling up its training programs and coalescing the trade community and expanding its outreach. Potential World Bank initiatives that would contribute to the successful achievement of PITAD's goals are also identified.

1. Strengthening PITAD Research Capacity

418. The recommendations here are based on (i) increasing the quality and scope of analytical work by introducing new methodologies, topics and data; (ii) increasing research productivity by developing systems to reduce fixed costs of analysis; and (iii) attracting and keeping high quality research staff. The short term and medium strategies for developing research capacity are discussed below.

- *Develop a database of national trade statistics.* A database of disaggregated (HS 8 digit) trade statistics would be useful to readily match tariff policy changes (instituted at the HS 8 digit) with changes in the trade flows. A monthly dataset of trade flows and a quarterly dataset of trade flows and markets would support PITAD's trade monitoring function, providing the latest trade trends to decision makers in the private and public sector. An interface to access data at various levels of aggregation with low fixed costs of entry would be essential. Partner: Federal Bureau of Statistics.
- *Establish Internal Database Repository.* It would also be important to create a data depository, where the data collected from different projects- those outsourced and done in-house- by various researchers are stored in a central location in the Institute so that they may be easily accessed by all researchers. Researchers would be responsible to provide supporting documentation to accompany the datasets.
- *Use a Statistical Package beyond EXCEL (e.g. STATA).* At the Institutional level, researchers should be encouraged to learn to work with a statistical package like STATA. As trade research now tends to be performed at very disaggregated product or firm level, research productivity would be highly advanced if researchers adopted a common statistical package such as STATA. STATA is recommended as it has excellent applications, is widely used internationally and PITAD computers already have STATA installed. Since STATA usage is primarily a learning by doing exercise, it would be good to have all researchers working on it so that there would be cooperation among researchers to address any issues. A basic introduction could be provided, but no further structured training is encouraged. While there will be an initial fixed cost in adoption, the stream of benefits that follow would far outweigh these costs. This would then facilitate the increased use of econometrics in the analytic work.
- *Develop a "core" research program.* It is important to balance support to the MOC with a longer-term research agenda. It would be useful to identify a "core" research program, covering a few broad topics based on policy relevance and the strengths of the PITAD team. While the requirements of the MOC would point to important trade issues relevant to Pakistan, outputs may be required in a time sensitive manner that would not accommodate an extensive analysis. If such work was in the research 'core' then researchers should be encouraged to revisit the topic, and expand the analysis towards generation of a PITAD working paper. The identification of a 'core' would also then readily reveal which projects should be outsourced (those outside the core). Having a core program, would also give researchers the opportunity to pursue a research topic which could become important in the future but as yet has not been identified as important by the MOC.
- *Prioritize Econometric and Analytic work over CGE Modeling.* Computer General Equilibrium (CGE) models are valuable as a tool to gauge the trade and income effects of different liberalization scenarios, and are attractive in that their output is a precise number reflecting

welfare effects of a proposed policy change. However these simulation results are based on complex models, with several assumptions and data requirements, where results could be highly sensitive to parameter variation. Further, Pakistan estimates are based on an outdated input-output table that is only being currently updated. There is a high fixed cost of embarking on rigorous CGE modeling, and it is recommended that acquiring these skills are not a priority, and any needed studies could be outsourced. Instead the focus should be on moving on to more econometric work and more sophisticated analytical work. These would involve advanced gravity modeling, and analytics involving disaggregated data relating to export diversification, intensive and extensive margins of trade, product quality, exporter firm survival, regional integration, services export competitiveness, and NTMs.

- *Form a Research Advisory Board.* It is important to have a high profile research advisory board that could advise PITAD on its long-term research agenda. While the requirements of the MOC would point to important trade issues relevant to Pakistan, it would be useful to have a broader advisory board that may be more forward thinking and brings perspectives from outside the country. Besides the Senior PITAD researchers, the membership of the proposed Board could include:
 - MOC (1 member)
 - Pakistani academics (1 member)
 - Pakistan private sector (1 member)
 - High profile non-resident Pakistani economist (1 member)
 - High profile international academic/ economist familiar with Pakistan (1 member)

The members of the Board would be charged with reviewing the publications of PITAD and advising on the future directions for research. The external advisors could prove particularly useful in terms of funding sources, opportunities for training for PITAD staff, opportunities for collaboration and having an external advocate for the Institute. The Board would meet once a year. International members may cost effectively contribute to meetings by video conference or Skype, and make written submissions. Currently PITAD does not have is an internationally recognized high profile trade expert associated with it. It would be useful to have a prominent economist in the Advisory Board.

- *Resident Research Fellows.* In order to increase the technical capacity of its research staff, the PITAD should seek to secure Resident Research Fellows from abroad or within Pakistan for short periods, whose active research skills or areas of study would provide invaluable intellectual stimulation to senior as well as junior research staff. These academics should be focused on relevant research and should collaborate with senior staff or be allocated junior staff to provide research assistance; so that there is skills transfer.
- *External Research Fellows.* These research fellows that are not based at PITAD could economists/academics in Pakistan or abroad, but collaborate with PITAD staff. These titles should be carefully given so they remain a prestigious position.
- *Incentives to Attract and Retain High Quality Staff.* In order to provide high quality research and policy analysis, PITAD has to acquire and retain high quality human capital with strong

analytical, statistical and writing skills. Given the growth of research institutes and consultancy work in Pakistan, there is likely to be much competition for and poaching of well-trained researchers. Since PITAD staff do not have the job security of civil servants, they have to be compensated by higher wages and other non-monetary benefits. In order to retain staff, it may also be worth considering an incentive mechanism that gives them some additional payment for consultancies taken on by PITAD or consultancies that they bring in.

Apart from competitive salaries, PITAD's attraction must continue to be an active research conducive work environment encouraging active debate and discussion, with opportunities for training. While a "training of trainers" strategy may be cost effective, it would be also important to additionally expose young researchers to training abroad. It is great to see that contributions of junior staff are acknowledged by name for research assistance or given co-authorship when the contribution is substantial. In addition, PITAD would have to adjust to the regular turnover of young staff that will go on for further full time study. As the reputation of PITAD grows, it may become an attractive place for civil servants on the cusp of retirement. PITAD management needs to be vigilant that only active staff that could contribute effectively to the team are recruited.

- *Foreign Staff Exchange/placement.* Networks could be developed with a more mature research institute in the region to create opportunities for staff development through temporary leaves of absence. Compensation strategies may be negotiated with the partner institutes.

2. *Scaling Up Training Program*

419. The Institute's training goals have expanded beyond provision of its core Specialized Training Program (STP) to new entrants of the Commerce and Trade (C&T) officer cadre at the MOC. It is envisioned that the PITAD will identify continuous training needs of middle management at the MOC that would be met by PITAD in-house training, partnerships with outside academic institutions, or complete outsourcing of training to local or international institutions. This would include technical training as well as leadership and management training.

- *Completing Core STP Course Re-engineering.* A key training-related priority is to complete the revamping of PITAD flagship STP course in collaboration with the World Trade Institute (WTI), Switzerland. It is important that the new curriculum includes new topics such as heterogeneous firms and trade in tasks.
- *Consolidation vs. Expansion.* Beyond the STP, PITAD has other shorter courses for foreign service officials, trade officers to be posted abroad, mid-level commerce officers and journalists. This is a strong portfolio and it is important to focus on upgrading all these shorter courses instead of expanding to cover new areas. The growth of PITAD's research wing will contribute to the medium-term development of the training program.
- *Opening up Internal Trainings.* Given the lack of a vibrant trade research community, it would be good if PITAD opened up some of its trainings to other officers in the Commerce ministry, relevant industry ministries, and researchers of the State Bank of Pakistan and the Federal Bureau of Statistics. Reciprocity would be expected under such an arrangement.

3. *Coalescing the Trade Community and Expanding Outreach*

420. The Institute can play an important role in coalescing the trade research community by bringing together the various stakeholders of trade policy making, in a convener and connector role. Convening conferences and workshops would be an excellent forum for policy discussion and debate. Policy dissemination through the publication of research papers and policy reports would also provide important information to relevant stakeholders.

- *Continue Working Paper Series.* Now that the Working Paper Series has been launched, it is imperative that it continues with the publication of more papers. A reasonable target focused of quality and quantity would be about 5 papers per year. There are many works in the pipeline and it is important to add them to the working paper list. In addition, it would be worthwhile to expand on quick policy outputs that revealed interesting results but were produced under short time constraints on request by the MOC. There is no need to spend money on printing these papers as long as they are freely available on the website. The publication of a clear, deep analysis on a pressing issue in trade policy would be invaluable to generating confidence in the analytical capacity and policy advice of the PITAD.
- *Updating the PITAD website.* The homepage of the PITAD website contains more information than is optimal. A streamlining of the website is needed and systems for regular updates at low cost need to be set in place. Currently, the website does not seem recently updated.
- *Organize Pakistan Trade and Development (PAKTAD) Conference.* This would be the launch of an annual trade conference in Pakistan.
- *Develop a Market Access Database Portal.* The nature of barriers to trade in the global economy has changed. Market access issues now focus increasingly on non-tariff and other “behind the border” measures in the markets of trading partners, compared to border tariffs. While some regulation of trade (human, animal and plant health, security-related) is important, the implementation of legitimate policies is sometimes manipulated for protective purposes. A user – friendly web portal that allows Pakistani exporters to register market access barriers especially NTMs would be useful for MOC policy negotiations and actions, and exporting success. The portal could be developed as a more modest hybrid of the European Commission’s Export Market Access Database madb.europa.eu/
- *Intra-regional and Extra-regional Networking.* Networking with intra-regional and extra-regional policy institutes should be accelerated as the Institute builds its research capacity.

4. *Potential Channels for World Bank Support*

421. Consistent with the World Bank’s strategy of moving to a “wholesale” model of research capacity building, the Bank could provide technical assistance in a variety of ways that introduces new techniques, data, and topics to Pakistani researchers. Provide technical assistance through Bank staff doing joint work with PITAD researchers, so they could impart new methodologies through learning-by-doing. Bank staff may spend extended time at PITAD, or a PITAD researcher could spend the summer months working on a joint research project. Advisory services include continuing research collaborations, mentoring young researchers and assisting with monitoring quality control.

- *Conferences, Workshops and Specific trainings.* Financing conferences on highly topical subjects and periodic workshops on research methodology.
 - Pakistan Trade and Development (PAKTAD) Conference
 - Empirical Methods in International Trade Workshop
 - Preferential Trade Agreements Training
- *Trade Database and Portal.* Support for the development of the trade database and portal—in line with supporting statistical capacity development and open data initiatives in developing countries.
- *Quarterly Trade Monitoring Report and the Annual Pakistan State of International Trade Report* - advisory services for development of these publications.
- *Export Competitiveness Toolkit.* Training on calculating and interpreting all the key indicators in the Trade Department's Export Competitiveness Toolkit.
- *Non-tariffs Measures* Project. Include Pakistan in NTMs stocktaking project of the Trade Department.
- *Innovation Policy.* Incorporate Pakistan in World Bank's efforts to build regional and global networks on innovation policy practitioners to facilitate locally-driven initiatives by mobilizing international "know-how" and facilitating practitioner exchange (including "south—south").

ANNEX 1. TOWARD ENHANCED COMPETITIVENESS AND EXPORT GROWTH
PAKISTAN'S TOP 45 EXPORTS AS SHARE OF TOTAL
(at 4 digit SITC level)

Code	Product Name	1990-99 Share in Total Exports (%)	2000-2006 Share in Total Exports (%)
6513	Cotton yarn	16.11	9.22
6522	Woven unb cotton fab nes	5.50	4.40
6523	Woven cotton finish<200g	4.77	1.70
6525	Woven cotton blend <200g	1.33	3.68
6529	Woven cotton fabrics nes	1.00	2.02
6531	Woven syn fil yarn fabrc	6.15	2.90
6552	Knit/croch fabric nes	0.94	0.63
6582	Tarpaulins/tents/blinds	0.62	0.48
6584	Bed/table/toilet linen	7.77	14.44
6585	Curtains etc nes	0.34	1.05
6589	Made-up textile arts nes	1.48	1.78
6592	Carpets etc. knotted	2.66	2.06
Textiles		48.68	44.36
8414	Men/boy trouser/etc wovn	1.88	3.11
8415	Mens/boys shirts, woven	1.58	0.77
8416	M/b under/night wear wvn	0.61	0.48
8426	Women/g trousers woven	0.33	1.00
8432	Men/b suits/etc knit/cr	0.35	0.77
8437	Men/boy knit/croch shirt	3.14	4.47
8447	Women/g blouses knit/cro	0.38	0.64
8454	T-shirts/singlets knit/c	0.63	1.14
8459	Apparel nes knit/crochet	1.36	1.47
8461	Clothing acc not knit/cr	0.58	0.93
8462	Panty hose/hosiery kn/cr	0.67	0.88
8481	Leather clothing/access	4.42	3.59
Garments		15.91	19.23
2631	Raw cotton,excl linters	3.43	0.61
2633	Cotton waste	0.63	0.33
Raw Cotton		4.06	0.94

Code	Product Name	1990-99 Share in Total Exports (%)	2000-2006 Share in Total Exports (%)
0423	Rice, milled	5.74	5.90
0342	Fish,frozen exc.fillet	0.43	0.51
0361	Crustaceans, frozen	1.02	0.34
0542	Dried legumes	0.01	0.22
0571	Citrus fruit fresh/dried	0.08	0.21
0579	Fruit fresh/dried nes	0.54	0.54
0612	Cane/beet sugar nes	0.64	0.10
0615	Molasses ex sugar refine	0.73	0.41
Food Products		9.20	8.26
6114	Bovine/equine leathr nes	0.86	0.92
6116	Goat/kid leather,no hair	1.31	0.85
8511	Footwear metal toe-cap	0.28	0.11
8514	Footwear leather upr nes	0.03	0.49
Leather and Footware		2.49	2.37
8947	Sports goods	2.99	2.53
8722	Medical.surg/vet instrum	1.41	1.15
Misc Manufactures		4.40	3.69
3330	Petrol./bitum. oil,crude	0.66	0.31
3344	Fuel oils,nes	0.24	2.72
5743	Polycarbonates/alk resin	0.01	0.52
Petrol & Chemical Products		0.90	3.54
6612	Portland etc cements	0.03	0.32
6633	Min material manuf nes	0.12	0.11
Cement		0.15	0.43
Total Top 42		85.80	82.83
Total Top 10		58.46	54.86

ANNEX 2. EXPORT COMPETITIVENESS AND GROWTH ISSUES: A CONCEPTUAL FRAMEWORK

1. Studies on competitiveness have made it clear that the determinants of competitiveness are many and complex. The arguments for investment in physical capital and infrastructure have been long present. Neoclassical economists, then, emphasized getting the macro fundamentals right so that resources naturally flow into the right sectors, and within those sectors, the right firms. Further, economists looked for other issues: human and social capital, hard and soft infrastructure, technological progress and innovation, business enabling environment, firm sophistication and demand conditions, product and market diversification, etc. There is now a general consensus among academics and practitioners that many of these arguments are not mutually exclusive but jointly supportive.

2. Competitiveness is a proxy of the productivity of an economy and depends on the value of a nation's products and services, measured by the prices they can command in international markets as well as the efficiency with which they can be produced. Productivity is subject to the basic minimum conditionality or the macro fundamentals of stability, sound markets and property rights regimes, effective and constructive regulation, good human resources, etc. But productivity and operational efficiency can often be increased through inter-firm and inter-industry linkages, spillovers, and synergies which require efficient access to public goods, better coordination and diffusion of best practices.

3. A good practice export competitiveness initiative underscores several of the above issues and draws on the myriad of policy tools and approaches employed around the world on trade, macroeconomic policy, customs and logistics, and direct enterprise support. It emphasizes the importance of global integration in achieving competitiveness – be it through new technologies, market-integrating economic policies. The policy agenda that typically emerges from a competitiveness analysis relates to three or four core areas. [Education and health is often considered a fourth distinct core area, but may be included in Supply Side Measures also.]

Macro fundamentals (e.g., removal of economic biases having to do with tariff and non-tariff barriers, real exchange rate misalignment, distortive tax regime, overall fiscal health of the economy, product and factor market conditions, property right protection, effective regulation, ease of firm entry and exit).

Services and costs (e.g., infrastructure, customs and trade logistics, the costs of doing business including compliance cost of regulation).

Proactive measures that try to correct market failures and develop public goods (e.g., technology creation and adaptation, product standards and certifications, export promotion, environmental and social standards, social safety nets).

Education and health (e.g., primary and higher education, vocational and on-the-job training, basic health care).

4. **Macro fundamentals are as necessary now as before.** No country ever achieved sustainable growth without have macroeconomic stability, removing protectionist measures, avoiding exchange rate biases and opening up markets. Although it is sometimes argued that the first generation reforms are complete in several countries, it remains a key challenge for policy makers to ensure that anti-trade biases are eradicated so that domestic resources can be channeled to their most productive activities.

5. Anti-trade biases can take various forms. High tariff rates and quantitative restrictions are conventional trade distorting policies but presence of import-export monopolies and various administrative restraints often make the situation especially prone to rent-seeking. Trading systems are

further distorted and segmented by the existence of preferential tariff rates and market access that are reciprocal to a subset of partner countries.

6. Real exchange rate misalignment can be detrimental to export growth, and the current devaluation of dollars as well as the inflationary pressures are likely to affect several countries. For example, the exceptional export growth of East Asian countries in the early 1990s was closely related to the ability of these countries to avoid real exchange rate overvaluation while minimizing exchange rate volatility.

7. Business taxes on investment also affect export orientation through its impact on investment decisions. Marginal effective tax rate (METR) on capital is a summary measure of the effective rate of tax imposed on the rate of return generated. The tax regime can impose biases against exporters, labor-intensive investments and against the small and medium enterprises (SMEs). It is important that countries continue to investigate ways to bring down the tax-related biases which may stand in their way to export competitiveness.

8. Deregulation of market is a must for the forces of competition to play. Any barriers in entry and exit of industries are likely to result in compromise in reaching the potentials of economic efficiency.

9. Factor markets are instrumental in achieving competitiveness: Constraints on factor markets often bar economies from achieving full competitive potentials. For example, poor access to credit, lack of skilled labor, biased land policies and lack of transparency in land management are things that come up as constraints on the way industries can attain highest degree of efficiency. These in turn lead to excessive informality, less than minimum efficient scale and cumbersome enforcement of business regulations.

10. **Reduced trade costs of infrastructure and related services contribute to competitiveness.** In order to effectively compete in the global markets, firms should have access to efficiently-produced critical backbone services and inputs. Countries where firms have to pay more than their competitors for energy, telecommunications, transport and logistics, business registration and operations, and business services will find it hard to compete in the global markets. If bureaucratic hurdles, lack of transparency and corruption are rampant, enterprises will find hard to compete even if they have high productivity within factory floors. As environmental agenda is gaining momentum and firms' track records on carbon footprints often add to not only their corporate social responsibility but also overall effectiveness of their brands and products.

11. **Supply side measures for enhancing competitiveness.** It is possible that industries need support to cover one-time expense of discovery of new products and gathering information on foreign markets, upgrading product quality and standards requirements, changing packaging, and establishing market channels. All these tasks require the coordination between public institutions and private stakeholders to work at multiple levels. This, in turn, will require each side to be aware of the strengths and limitations of the other, and be ready to step in when necessary and feasible. Such complementarities become especially important as local markets integrate with global, and export competitiveness becomes more and more the function of broader technological and organizational efficiency than individual firm-specific characteristics.

12. **The importance of basic health and education remains clear.** The past experiences on global integration, especially in more sophisticated industries, have put the agenda of specialized education and vocational training back at the forefront of the competitiveness agenda.

13. **Despite the codification and structure described above, a competitiveness strategy should not be static but dynamic.** Although the macroeconomic fundamentals and human resources remain key

to competitiveness, the new paradigm of competitiveness is very much about getting the microeconomic business environment right. Although business environment is equated with the ease of business regulations, it may be useful to think of this term more broadly, consisting public or semi-public institutions covering innovation and R&D, standards and certification, skills enhancement, export promotion, etc. Such cannot be responsibilities of the private sectors alone nor that of the public sectors alone. In essence, several of these are not industry-specific issues either, but issues that affect the functioning of various industrial clusters and the way each is connected with the other. The challenge of each competitiveness program will be in applying the broad pro forma framework on trade competitiveness into a meaningful policy dialogue and strategic initiative that works towards removing specific binding constraints in Pakistan.

14. To maximize the effectiveness of interventions, the authorities need to be able to quickly spot deficiencies or changing conditions and make course corrections. The pre-requisites for this dynamic approach include:

A realistic plan that is observant of the diverse factors and stakeholders involved, is anticipatory of any global or local changes rising to the surface.

An institutionalized and inclusive process of consultation with the private sector in the design, monitoring and evaluation of interventions

Transparency in implicit or explicit subsidies involved in the interventions

Clear, measurable and transparent indicators of success of each intervention

Arms-length relations between the government and the private sector

A public governance set-up that ensures that the government is bound by sufficient accountability to be able to prevent capture and to interrupt failing interventions.

ANNEX 3. TOWARD ENHANCED COMPETITIVENESS AND EXPORT GROWTH

A Cluster Based Approach

1. Improving competitiveness mostly depends on the pace at which firms within an economy shift from competing on basic and inherited endowments to competing on advantages arising from efficient and distinctive processes and products that contain as much added value as possible. Within firms, such a shift will require innovation of products, processes, and markets, adaptation of new technologies, and new partnerships among productive forces, such as workers, suppliers, service providers, and buyers.

2. Beyond firms, the shift will require parallel changes in the surrounding microeconomic business environment, which will depend on the mobilization of private and public sector actors and institutions. While microeconomic business environment is fundamental but development of public institutions that proactively support value addition by firms at a collective level are also important, such as those covering innovation and R&D, standards and certification, skills enhancement and export promotion.

3. A cluster-based approach combines economy-wide and industry-wide analyses such that consultations with the public and private sector bodies are managed such that they form the platforms on which public-private partnerships are sought and achieved at an incremental pace. A typical cluster initiative model will begin with cluster mapping which will outline cluster-economy embeddedness on the one hand, and on the other, it will show cluster composition typically involving producers and suppliers, service providers, regulators and standard setters, and policymakers from the key public institutions. Lifespan of a cluster analysis involves three broad components:

First, facilitators will apply tools that emphasize on interaction among cluster members from both public and private domains (e.g., product/market segmentation, SWOT, GAP and Porter's Five-Forces analyses);

Second, industry experts are brought in to undertake more rigorous analyses that are done jointly with the private sector actors (e.g., value chain analysis, market trend analysis, competitiveness positioning);

4. The above two are deeply intertwined with clusters' strategy formulations on behavior change within firms where the private sector actors have to invest in kind or in cash. This is matched by reforms in public supporting institutions to bring changes in microeconomic business environment covering innovation, and R&D, standards and certification, skills enhancement and export promotion.

5. ***Facilitating Public—Private and Private—Private Dialogue (PPD).*** Interface and partnerships between and within the public and private sectors are crucial to address key constraints to existing activities. This is due to the fact that the ultimate success of a competitiveness strategy is influenced by the fact that (i) governments can rarely pick winners, (ii) the private sector has difficulty creating public goods or taking collective action, (iii) competitiveness often is boosted from collaboration of industry with academic and applied research institutions, and (iv) the body of policy reforms and specific initiatives affecting competitiveness involves a cross section of government institutions. However, though the private sector can have a positive role—such as helping the public sector coordinate and monitor proactive measures to unleash firm level competitiveness – public and private sector bodies often find it challenging to achieve aligned objectives and work productively together.

6. In Pakistan, the private sector is highly active in policy making through a number of formal and informal avenue. Leading business voices are present in high level committees sponsored by the Ministry

of Finance (*The Economic Advisory Committee*) and the Planning Commission (*The PSD Task Force*). Some of these same leading businesses have also formed the *Pakistan Business Council* a private sector run and funded think-tank which carries out policy analysis of key issues facing Pakistan's business sector. The strong PPD tradition in Pakistan is a good foundation to identify new ways for the public and private sectors to work together for common objectives.

7. The project will first assess various PPD and initiatives in Pakistan, with a particular attention to those which focus on policy advocacy to influence levels of leadership, build consensus with stakeholders, effectively coordinate inputs, mobilize resources and push forward an implementation agenda. Based on the lessons learned in Policy Notes 4 and 5, and a stocktaking of current PPD activities in Pakistan, the component will specify (i) an agreed upon set of targeted outcomes shared by the public and private sector, (ii) an appropriate mode of engagement between government, private sector, donors, and any other key stakeholders, (iii) identification of issue-specific, sector-specific and/or cluster-based approaches to engage, and (iv) checks and balances, for an effective PPD institution, including a monitoring and evaluation framework for targeted outcomes. The Bank team will liaise closely with other donors in the field including ADB, USAID and DFID as well as related project such as the Competitiveness Support Fund (CSF) which has been in existence since 2005-06.¹⁴⁶

8. Issues identification, engagement methodology and success indicators for the PPD stock taking and pilot PPD approach to cluster development will be determined within the context of Policy Notes 4 and 5. While the Ministry of Commerce will oversee and sponsor the effort, the precise institutional counterparts on the public and private side will also be determined at that time. The case study will be written up and published as a pilot, but will also include a plan (i.e. methods, institutions, costs, etc) for scaling up the pilot to other cases.

¹⁴⁶ USAID is exploring the setting up a panel of "competitiveness councils" of private sector, government, academia and civil society representation in 20 districts.